

## Berkshire's Performance vs. the S&P 500

Year	Annual Percentage Change		
	in Per-Share Book Value of Berkshire	in Per-Share Market Value of Berkshire	in S&P 500 with Dividends Included
1965	23.8	49.5	10.0
1966	20.3	(3.4)	(11.7)
1967	11.0	13.3	30.9
1968	19.0	77.8	11.0
1969	16.2	19.4	(8.4)
1970	12.0	(4.6)	3.9
1971	16.4	80.5	14.6
1972	21.7	8.1	18.9
1973	4.7	(2.5)	(14.8)
1974	5.5	(48.7)	(26.4)
1975	21.9	2.5	37.2
1976	59.3	129.3	23.6
1977	31.9	46.8	(7.4)
1978	24.0	14.5	6.4
1979	35.7	102.5	18.2
1980	19.3	32.8	32.3
1981	31.4	31.8	(5.0)
1982	40.0	38.4	21.4
1983	32.3	69.0	22.4
1984	13.6	(2.7)	6.1
1985	48.2	93.7	31.6
1986	26.1	14.2	18.6
1987	19.5	4.6	5.1
1988	20.1	59.3	16.6
1989	44.4	84.6	31.7
1990	7.4	(23.1)	(3.1)
1991	39.6	35.6	30.5
1992	20.3	29.8	7.6
1993	14.3	38.9	10.1
1994	13.9	25.0	1.3
1995	43.1	57.4	37.6
1996	31.8	6.2	23.0
1997	34.1	34.9	33.4
1998	48.3	52.2	28.6
1999	0.5	(19.9)	21.0
2000	6.5	26.6	(9.1)
2001	(6.2)	6.5	(11.9)
2002	10.0	(3.8)	(22.1)
2003	21.0	15.8	28.7
2004	10.5	4.3	10.9
2005	6.4	0.8	4.9
2006	18.4	24.1	15.8
2007	11.0	28.7	5.5
2008	(9.6)	(31.8)	(37.0)
2009	19.8	2.7	26.5
2010	13.0	21.4	15.1
2011	4.6	(4.7)	2.1
2012	14.4	16.8	16.0
2013	18.2	32.7	32.4
2014	8.3	27.0	13.7

Compounded Annual Gain – 1965-2014	19.4%	21.6%	9.9%
Overall Gain – 1964-2014	751,113%	1,826,163%	11,196%

**Notes:** Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31. Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported. The S&P 500 numbers are **pre-tax** whereas the Berkshire numbers are **after-tax**. If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P 500 in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

A note to readers: Fifty years ago, today's management took charge at Berkshire. For this Golden Anniversary, Warren Buffett and Charlie Munger each wrote his views of what has happened at Berkshire during the past 50 years and what each expects during the next 50. Neither changed a word of his commentary after reading what the other had written. Warren's thoughts begin on page 24 and Charlie's on page 39. Shareholders, particularly new ones, may find it useful to read those letters before reading the report on 2014, which begins below.

## **BERKSHIRE HATHAWAY INC.**

### **To the Shareholders of Berkshire Hathaway Inc.:**

Berkshire's gain in net worth during 2014 was \$18.3 billion, which increased the per-share book value of both our Class A and Class B stock by 8.3%. Over the last 50 years (that is, since present management took over), per-share book value has grown from \$19 to \$146,186, a rate of 19.4% compounded annually.\*

During our tenure, we have consistently compared the yearly performance of the S&P 500 to the change in Berkshire's per-share book value. We've done that because book value has been a crude, but useful, *tracking device* for the number that really counts: intrinsic business value.

In our early decades, the relationship between book value and intrinsic value was much closer than it is now. That was true because Berkshire's assets were then largely securities whose values were continuously restated to reflect their current market prices. In Wall Street parlance, most of the assets involved in the calculation of book value were "marked to market."

Today, our emphasis has shifted in a major way to owning and operating large businesses. Many of these are worth far more than their cost-based carrying value. But that amount is *never* revalued upward no matter how much the value of these companies has increased. Consequently, the gap between Berkshire's intrinsic value and its book value has materially widened.

With that in mind, we have added a new set of data – the historical record of Berkshire's stock price – to the performance table on the facing page. Market prices, let me stress, have their limitations in the short term. Monthly or yearly movements of stocks are often erratic and not indicative of changes in intrinsic value. Over time, however, stock prices and intrinsic value almost invariably converge. Charlie Munger, Berkshire Vice Chairman and my partner, and I believe that has been true at Berkshire: In our view, the increase in Berkshire's per-share intrinsic value over the past 50 years is roughly equal to the 1,826,163% gain in market price of the company's shares.

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\* All per-share figures used in this report apply to Berkshire's A shares. Figures for the B shares are 1/1500<sup>th</sup> of those shown for A.

## The Year at Berkshire

It was a good year for Berkshire on all major fronts, except one. Here are the important developments:

- Our “Powerhouse Five” – a collection of Berkshire’s largest non-insurance businesses – had a record \$12.4 billion of pre-tax earnings in 2014, up \$1.6 billion from 2013.\* The companies in this sainted group are Berkshire Hathaway Energy (formerly MidAmerican Energy), BNSF, IMC (I’ve called it Iscar in the past), Lubrizol and Marmon.

Of the five, only Berkshire Hathaway Energy, then earning \$393 million, was owned by us a decade ago. Subsequently we purchased another three of the five on an all-cash basis. In acquiring the fifth, BNSF, we paid about 70% of the cost in cash and, for the remainder, issued Berkshire shares that increased the number outstanding by 6.1%. In other words, the \$12 billion gain in annual earnings delivered Berkshire by the five companies over the ten-year span has been accompanied by only minor dilution. That satisfies our goal of not simply increasing earnings, but making sure we also increase *per-share* results.

If the U.S. economy continues to improve in 2015, we expect earnings of our Powerhouse Five to improve as well. The gain could reach \$1 billion, in part because of bolt-on acquisitions by the group that have already closed or are under contract.

- Our bad news from 2014 comes from our group of five as well and is unrelated to earnings. During the year, BNSF disappointed many of its customers. These shippers depend on us, and service failures can badly hurt their businesses.

BNSF is, by far, Berkshire’s most important non-insurance subsidiary and, to improve its performance, we will spend \$6 billion on plant and equipment in 2015. That sum is nearly 50% more than any other railroad has spent in a single year and is a truly extraordinary amount, whether compared to revenues, earnings or depreciation charges.

Though weather, which was particularly severe last year, will always cause railroads a variety of operating problems, our responsibility is to do *whatever it takes* to restore our service to industry-leading levels. That can’t be done overnight: The extensive work required to increase system capacity sometimes disrupts operations while it is underway. Recently, however, our outsized expenditures are beginning to show results. During the last three months, BNSF’s performance metrics have materially improved from last year’s figures.

- Our many dozens of smaller non-insurance businesses earned \$5.1 billion last year, up from \$4.7 billion in 2013. Here, as with our Powerhouse Five, we expect further gains in 2015. Within this group, we have two companies that last year earned between \$400 million and \$600 million, six that earned between \$250 million and \$400 million, and seven that earned between \$100 million and \$250 million. This collection of businesses will increase in both number and earnings. Our ambitions have no finish line.
- Berkshire’s huge and growing insurance operation again operated at an underwriting profit in 2014 – that makes 12 years in a row – and increased its float. During that 12-year stretch, our float – money that doesn’t belong to us but that we can invest for Berkshire’s benefit – has grown from \$41 billion to \$84 billion. Though neither that gain nor the size of our float is reflected in Berkshire’s earnings, float generates significant investment income because of the assets it allows us to hold.

\* Throughout this letter, as well as in the “Golden Anniversary” letters included later in this report, all earnings are stated on a pre-tax basis unless otherwise designated.

Meanwhile, our underwriting profit totaled \$24 billion during the twelve-year period, including \$2.7 billion earned in 2014. And all of this began with our 1967 purchase of National Indemnity for \$8.6 *million*.

- While Charlie and I search for new businesses to buy, our many subsidiaries are regularly making bolt-on acquisitions. Last year was particularly fruitful: We contracted for 31 bolt-ons, scheduled to cost \$7.8 billion in aggregate. The size of these transactions ranged from \$400,000 to \$2.9 billion. However, the largest acquisition, Duracell, will not close until the second half of this year. It will then be placed under Marmon's jurisdiction.

Charlie and I encourage bolt-ons, *if* they are sensibly-priced. (Most deals offered us aren't.) They deploy capital in activities that fit with our existing businesses and that will be managed by our corps of expert managers. This means no more work for us, yet more earnings, a combination we find particularly appealing. We will make many more of these bolt-on deals in future years.

- Two years ago my friend, Jorge Paulo Lemann, asked Berkshire to join his 3G Capital group in the acquisition of Heinz. My affirmative response was a no-brainer: I knew immediately that this partnership would work well from both a personal and financial standpoint. And it most definitely has.

I'm not embarrassed to admit that Heinz is run far better under Alex Behring, Chairman, and Bernardo Hees, CEO, than would be the case if I were in charge. They hold themselves to extraordinarily high performance standards and are never satisfied, even when their results far exceed those of competitors.

We expect to partner with 3G in more activities. Sometimes our participation will only involve a financing role, as was the case in the recent acquisition of Tim Hortons by Burger King. Our favored arrangement, however, will usually be to link up as a *permanent* equity partner (who, in some cases, contributes to the financing of the deal as well). Whatever the structure, we feel good when working with Jorge Paulo.

Berkshire also has fine partnerships with Mars and Leucadia, and we may form new ones with them or with other partners. Our participation in any joint activities, whether as a financing or equity partner, will be limited to friendly transactions.

- In October, we contracted to buy Van Tuyl Automotive, a group of 78 automobile dealerships that is exceptionally well-run. Larry Van Tuyl, the company's owner, and I met some years ago. He then decided that if he were ever to sell his company, its home should be Berkshire. Our purchase was recently completed, and we are now "car guys."

Larry and his dad, Cecil, spent 62 years building the group, following a strategy that made owner-partners of all local managers. Creating this mutuality of interests proved over and over to be a winner. Van Tuyl is now the fifth-largest automotive group in the country, with per-dealership sales figures that are outstanding.

In recent years, Jeff Rachor has worked alongside Larry, a successful arrangement that will continue. There are about 17,000 dealerships in the country, and ownership transfers always require approval by the relevant auto manufacturer. Berkshire's job is to perform in a manner that will cause manufacturers to welcome further purchases by us. If we do this – and if we can buy dealerships at sensible prices – we will build a business that before long will be multiples the size of Van Tuyl's \$9 billion of sales.

With the acquisition of Van Tuyl, Berkshire now owns 9 ½ companies that would be listed on the Fortune 500 were they independent (Heinz is the ½). That leaves 490 ½ fish in the sea. Our lines are out.

- Our subsidiaries spent a record \$15 billion on plant and equipment during 2014, well over twice their depreciation charges. About 90% of that money was spent in the United States. Though we will always invest abroad as well, the mother lode of opportunities runs through America. The treasures that have been uncovered up to now are dwarfed by those still untapped. Through dumb luck, Charlie and I were born in the United States, and we are forever grateful for the staggering advantages this accident of birth has given us.
- Berkshire's yearend employees – including those at Heinz – totaled a record 340,499, up 9,754 from last year. The increase, I am proud to say, included no gain at headquarters (where 25 people work). No sense going crazy.
- Berkshire increased its ownership interest last year in each of its “Big Four” investments – American Express, Coca-Cola, IBM and Wells Fargo. We purchased additional shares of IBM (increasing our ownership to 7.8% versus 6.3% at yearend 2013). Meanwhile, stock repurchases at Coca-Cola, American Express and Wells Fargo raised our percentage ownership of each. Our equity in Coca-Cola grew from 9.1% to 9.2%, our interest in American Express increased from 14.2% to 14.8% and our ownership of Wells Fargo grew from 9.2% to 9.4%. And, if you think tenths of a percent aren't important, ponder this math: For the four companies in aggregate, each increase of one-tenth of a percent in our ownership raises Berkshire's portion of their annual earnings by \$50 million.

These four investees possess excellent businesses and are run by managers who are both talented and shareholder-oriented. At Berkshire, we much prefer owning a non-controlling but substantial portion of a wonderful company to owning 100% of a so-so business. It's better to have a partial interest in the Hope Diamond than to own all of a rhinestone.

If Berkshire's yearend holdings are used as the marker, our portion of the “Big Four's” 2014 earnings before discontinued operations amounted to \$4.7 billion (compared to \$3.3 billion only three years ago). In the earnings we report to you, however, we include only the dividends we receive – about \$1.6 billion last year. (Again, three years ago the dividends were \$862 million.) But make no mistake: The \$3.1 billion of these companies' earnings we don't report are every bit as valuable to us as the portion Berkshire records.

The earnings these investees retain are often used for repurchases of their own stock – a move that enhances Berkshire's share of future earnings without requiring us to lay out a dime. Their retained earnings also fund business opportunities that usually turn out to be advantageous. All that leads us to expect that the per-share earnings of these four investees, in aggregate, will grow substantially over time (though 2015 will be a tough year for the group, in part because of the strong dollar). If the expected gains materialize, dividends to Berkshire will increase and, even more important, so will our unrealized capital gains. (For the package of four, our unrealized gains already totaled \$42 billion at yearend.)

Our flexibility in capital allocation – our willingness to invest large sums passively in non-controlled businesses – gives us a significant advantage over companies that limit themselves to acquisitions they can operate. Our appetite for *either* operating businesses or passive investments doubles our chances of finding sensible uses for Berkshire's endless gusher of cash.

- I've mentioned in the past that my experience in business helps me as an investor and that my investment experience has made me a better businessman. Each pursuit teaches lessons that are applicable to the other. And some truths can only be fully learned through experience. (In Fred Schwed's wonderful book, *Where Are the Customers' Yachts?*, a Peter Arno cartoon depicts a puzzled Adam looking at an eager Eve, while a caption says, “There are certain things that cannot be adequately explained to a virgin either by words or pictures.” If you haven't read Schwed's book, buy a copy at our annual meeting. Its wisdom and humor are truly priceless.)

Among Arno's "certain things," I would include two separate skills, the evaluation of investments and the management of businesses. I therefore think it's worthwhile for Todd Combs and Ted Weschler, our two investment managers, to each have oversight of at least one of our businesses. A sensible opportunity for them to do so opened up a few months ago when we agreed to purchase two companies that, though smaller than we would normally acquire, have excellent economic characteristics. Combined, the two earn \$100 million annually on about \$125 million of net tangible assets.

I've asked Todd and Ted to each take on one as Chairman, in which role they will function in the very limited way that I do with our larger subsidiaries. This arrangement will save me a minor amount of work and, more important, make the two of them even better investors than they already are (which is to say among the best).

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Late in 2009, amidst the gloom of the Great Recession, we agreed to buy BNSF, the largest purchase in Berkshire's history. At the time, I called the transaction an "all-in wager on the economic future of the United States."

That kind of commitment was nothing new for us. We've been making similar wagers ever since Buffett Partnership Ltd. acquired control of Berkshire in 1965. For good reason, too: Charlie and I have always considered a "bet" on ever-rising U.S. prosperity to be very close to a sure thing.

Indeed, who has ever benefited during the past 238 years by betting *against* America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, *real* per-capita U.S. output has *sextupled*. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket).

The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.

With this tailwind working for us, Charlie and I hope to build Berkshire's per-share intrinsic value by (1) constantly improving the basic earning power of our many subsidiaries; (2) further increasing their earnings through bolt-on acquisitions; (3) benefiting from the growth of our investees; (4) repurchasing Berkshire shares when they are available at a meaningful discount from intrinsic value; and (5) making an occasional large acquisition. We will also try to maximize results for *you* by rarely, if ever, issuing Berkshire shares.

Those building blocks rest on a rock-solid foundation. A century hence, BNSF and Berkshire Hathaway Energy will still be playing vital roles in our economy. Homes and autos will remain central to the lives of most families. Insurance will continue to be essential for both businesses and individuals. Looking ahead, Charlie and I see a world made to order for Berkshire. We feel fortunate to be entrusted with its management.

## **Intrinsic Business Value**

As much as Charlie and I talk about intrinsic business value, we cannot tell you precisely what that number is for Berkshire shares (nor, in fact, for any other stock). In our 2010 annual report, however, we laid out the three elements – one of them qualitative – that we believe are the keys to a sensible estimate of Berkshire's intrinsic value. That discussion is reproduced in full on pages 123-124.

Here is an update of the two quantitative factors: In 2014 our per-share investments increased 8.4% to \$140,123, and our earnings from businesses other than insurance and investments increased 19% to \$10,847 per share.

Since 1970, our per-share investments have increased at a rate of 19% compounded annually, and our earnings figure has grown at a 20.6% clip. It is no coincidence that the price of Berkshire stock over the ensuing 44 years has increased at a rate very similar to that of our two measures of value. Charlie and I like to see gains in both sectors, but our main focus is to build operating earnings. That's why we were pleased to exchange our Phillips 66 and Graham Holdings stock for operating businesses last year and to contract with Procter and Gamble to acquire Duracell by means of a similar exchange set to close in 2015.

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Now, let's examine the four major sectors of our operations. Each has vastly different balance sheet and income characteristics from the others. So we'll present them as four separate businesses, which is how Charlie and I view them (though there are important and *enduring* advantages to having them all under one roof). Our goal is to provide you with the information we would wish to have if our positions were reversed, with you being the reporting manager and we the absentee shareholders. (But don't get any ideas!)

## Insurance

Let's look first at insurance, Berkshire's core operation. That industry has been the engine that has propelled our expansion since 1967, when we acquired National Indemnity and its sister company, National Fire & Marine, for \$8.6 million. Though that purchase had monumental consequences for Berkshire, its execution was simplicity itself.

Jack Ringwalt, a friend of mine who was the controlling shareholder of the two companies, came to my office saying he would like to sell. Fifteen minutes later, we had a deal. Neither of Jack's companies had ever had an audit by a public accounting firm, and I didn't ask for one. My reasoning: (1) Jack was honest and (2) He was also a bit quirky and likely to walk away if the deal became at all complicated.

On pages 128-129, we reproduce the 1½-page purchase agreement we used to finalize the transaction. That contract was homemade: Neither side used a lawyer. Per page, this has to be Berkshire's best deal: National Indemnity today has GAAP (generally accepted accounting principles) net worth of \$111 billion, which exceeds that of any other insurer in the world.

One reason we were attracted to the property-casualty business was its financial characteristics: P/C insurers receive premiums upfront and pay claims later. In extreme cases, such as those arising from certain workers' compensation accidents, payments can stretch over many decades. This collect-now, pay-later model leaves P/C companies holding large sums – money we call “float” – that will eventually go to others. Meanwhile, insurers get to invest this float for their benefit. Though individual policies and claims come and go, the amount of float an insurer holds usually remains fairly stable in relation to premium volume. Consequently, as our business grows, so does our float. And *how* we have grown, as the following table shows:

<u>Year</u>	<u>Float (in \$ millions)</u>
1970	\$ 39
1980	237
1990	1,632
2000	27,871
2010	65,832
2014	83,921

Further gains in float will be tough to achieve. On the plus side, GEICO and our new commercial insurance operation are almost certain to grow at a good clip. National Indemnity's reinsurance division, however, is party to a number of run-off contracts whose float drifts downward. If we do in time experience a decline in float, it will be *very* gradual – at the outside no more than 3% in any year. The nature of our insurance contracts is such that we can *never* be subject to immediate demands for sums that are large compared to our cash resources. This strength is a key pillar in Berkshire's economic fortress.



If our premiums exceed the total of our expenses and eventual losses, we register an underwriting profit that adds to the investment income our float produces. When such a profit is earned, we enjoy the use of free money – and, better yet, get *paid* for holding it.

Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous indeed that it frequently causes the P/C industry as a whole to operate at a significant underwriting *loss*. This loss, in effect, is what the industry pays to hold its float. Competitive dynamics almost guarantee that the insurance industry, despite the float income all its companies enjoy, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses. The prolonged period of low interest rates our country is now dealing with causes earnings on float to decrease, thereby exacerbating the profit problems of the industry.

As noted in the first section of this report, Berkshire has now operated at an underwriting profit for twelve consecutive years, our pre-tax gain for the period having totaled \$24 billion. Looking ahead, I believe we will continue to underwrite profitably in most years. Doing so is the daily focus of *all* of our insurance managers, who know that while float is valuable, its benefits can be drowned by poor underwriting results. That message is given at least lip service by all insurers; at Berkshire it is a religion.

So how does our float affect intrinsic value? When Berkshire's *book* value is calculated, the *full* amount of our float is deducted as a *liability*, just as if we had to pay it out tomorrow and could not replenish it. But to think of float as strictly a liability is incorrect; it should instead be viewed as a revolving fund. Daily, we pay old claims and related expenses – a huge \$22.7 billion to more than six million claimants in 2014 – and that reduces float. Just as surely, we each day write new business and thereby generate new claims that add to float.

If our revolving float is both costless and long-enduring, which I believe it will be, the true value of this liability is *dramatically* less than the accounting liability. Owing \$1 that in effect will never leave the premises – because new business is almost certain to deliver a substitute – is worlds different from owing \$1 that will go out the door tomorrow and not be replaced. The two types of liabilities are treated as equals, however, under GAAP.

A partial offset to this overstated liability is a \$15.5 billion “goodwill” asset that we incurred in buying our insurance companies and that increases book value. In very large part, this goodwill represents the price we paid for the float-generating capabilities of our insurance operations. The cost of the goodwill, however, has *no* bearing on its true value. For example, if an insurance company sustains large and prolonged underwriting losses, *any* goodwill asset carried on the books should be deemed valueless, whatever its original cost.

Fortunately, that does not describe Berkshire. Charlie and I believe the true economic value of our insurance goodwill – what we would happily pay for float *of similar quality* were we to purchase an insurance operation possessing it – to be *far* in excess of its historic carrying value. Under present accounting rules (with which we agree) this excess value will *never* be entered on our books. But I can assure you that it's real. That's one reason – a huge reason – why we believe Berkshire's intrinsic business value substantially exceeds its book value.

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Berkshire's attractive insurance economics exist only because we have some terrific managers running disciplined operations that possess hard-to-replicate business models. Let me tell you about the major units.

First by float size is the Berkshire Hathaway Reinsurance Group, managed by Ajit Jain. Ajit insures risks that no one else has the desire or the capital to take on. His operation combines capacity, speed, decisiveness and, most important, brains in a manner unique in the insurance business. Yet he never exposes Berkshire to risks that are inappropriate in relation to our resources.



Indeed, we are *far* more conservative in avoiding risk than most large insurers. For example, if the insurance industry should experience a \$250 billion loss from some mega-catastrophe – a loss about triple anything it has ever experienced – Berkshire as a whole would likely record a significant profit for the year because of its many streams of earnings. We would also remain awash in cash and be looking for large opportunities in a market that might well have gone into shock. Meanwhile, other major insurers and reinsurers would be far in the red, if not facing insolvency.

Ajit's underwriting skills are unmatched. His mind, moreover, is an idea factory that is always looking for more lines of business he can add to his current assortment. Last year I told you about his formation of Berkshire Hathaway Specialty Insurance ("BHSI"). This initiative took us into commercial insurance, where we were instantly welcomed by both major insurance brokers and corporate risk managers throughout America. Previously, we had written only a few specialized lines of commercial insurance.

BHSI is led by Peter Eastwood, an experienced underwriter who is widely respected in the insurance world. During 2014, Peter expanded his talented group, moving into both international business and new lines of insurance. We repeat last year's prediction that BHSI will be a major asset for Berkshire, one that will generate volume in the billions within a few years.

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We have another reinsurance powerhouse in General Re, managed by Tad Montross.

At bottom, a sound insurance operation needs to adhere to four disciplines. It must (1) understand *all* exposures that might cause a policy to incur losses; (2) conservatively assess the likelihood of any exposure actually causing a loss and the probable cost if it does; (3) set a premium that, on average, will deliver a profit after both prospective loss costs and operating expenses are covered; and (4) be willing to walk away if the appropriate premium can't be obtained.

Many insurers pass the first three tests and flunk the fourth. They simply can't turn their back on business that is being eagerly written by their competitors. That old line, "The other guy is doing it, so we must as well," spells trouble in any business, but in none more so than insurance.

Tad has observed all four of the insurance commandments, and it shows in his results. General Re's huge float has been considerably better than cost-free under his leadership, and we expect that, on average, to continue. We are particularly enthusiastic about General Re's international life reinsurance business, which has grown consistently and profitably since we acquired the company in 1998.

It can be remembered that soon after we purchased General Re, it was beset by problems that caused commentators – and me as well, briefly – to believe I had made a huge mistake. That day is long gone. General Re is now a gem.

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Finally, there is GEICO, the insurer on which I cut my teeth 64 years ago. GEICO is managed by Tony Nicely, who joined the company at 18 and completed 53 years of service in 2014. Tony became CEO in 1993, and since then the company has been flying. There is *no* better manager than Tony.

When I was first introduced to GEICO in January 1951, I was blown away by the huge cost advantage the company enjoyed compared to the expenses borne by the giants of the industry. It was clear to me that GEICO would succeed because it *deserved* to succeed. No one *likes* to buy auto insurance. Almost everyone, though, likes to drive. The insurance consequently needed is a major expenditure for most families. Savings matter to them – and *only* a low-cost operation can deliver these. Indeed, at least 40% of the people reading this letter can save money by insuring with GEICO. So stop reading and go to [geico.com](http://geico.com) or call 800-368-2734.

GEICO's cost advantage is the factor that has enabled the company to gobble up market share year after year. (We ended 2014 at 10.8% compared to 2.5% in 1995, when Berkshire acquired control of GEICO.) The company's low costs create a moat – an *enduring* one – that competitors are unable to cross. Our gecko never tires of telling Americans how GEICO can save them important money. The gecko, I should add, has one particularly endearing quality – he works without pay. Unlike a human spokesperson, he never gets a swelled head from his fame nor does he have an agent to constantly remind us how valuable he is. I love the little guy.

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In addition to our three major insurance operations, we own a group of smaller companies, most of them plying their trade in odd corners of the insurance world. In aggregate, these companies are a growing operation that consistently delivers an underwriting profit. Indeed, over the past decade, they have earned \$2.95 billion from underwriting while growing their float from \$1.7 billion to \$8.6 billion. Charlie and I treasure these companies and their managers.

<u>Insurance Operations</u>	<u>Underwriting Profit</u> (in millions)		<u>Yearend Float</u>	
	<u>2014</u>	<u>2013</u>	<u>2014</u>	<u>2013</u>
BH Reinsurance .....	\$ 606	\$1,294	\$42,454	\$37,231
General Re .....	277	283	19,280	20,013
GEICO .....	1,159	1,127	13,569	12,566
Other Primary .....	<u>626</u>	<u>385</u>	<u>8,618</u>	<u>7,430</u>
	<u>\$2,668</u>	<u>\$3,089</u>	<u>\$83,921</u>	<u>\$77,240</u>

\* \* \* \* \*

Simply put, insurance is the sale of promises. The “customer” pays money now; the insurer promises to pay money in the future should certain unwanted events occur.

Sometimes, the promise will not be tested for decades. (Think of life insurance bought by people in their 20s.) Therefore, both the ability and willingness of the insurer to pay, even if economic chaos prevails when payment time arrives, is all-important.

Berkshire's promises have no equal, a fact affirmed in recent years by certain of the world's largest and most sophisticated P/C insurers, who wished to shed themselves of huge and exceptionally long-lived liabilities. That is, these insurers wished to “cede” these liabilities – most of them potential losses from asbestos claims – to a reinsurer. They needed the right one, though: If a reinsurer fails to pay a loss, the original insurer is still on the hook for it. Choosing a reinsurer, therefore, that down the road proves to be financially strapped or a bad actor threatens the original insurer with getting huge liabilities right back in its lap.

Last year, our premier position in reinsurance was reaffirmed by our writing a policy carrying a \$3 billion single premium. I believe that the policy's size has only been exceeded by our 2007 transaction with Lloyd's, in which the premium was \$7.1 billion.

In fact, I know of only eight P/C policies in history that had a single premium exceeding \$1 billion. And, yes, all eight were written by Berkshire. Certain of these contracts will require us to make substantial payments 50 years or more from now. When major insurers have needed an unquestionable promise that payments of this type will be made, Berkshire has been the party – the *only* party – to call.

\* \* \* \* \*

Berkshire's great managers, premier financial strength and a variety of business models protected by wide moats amount to something unique in the insurance world. This assemblage of strengths is a huge asset for Berkshire shareholders that will only get more valuable with time.

## Regulated, Capital-Intensive Businesses

We have two major operations, BNSF and Berkshire Hathaway Energy (“BHE”), that share important characteristics distinguishing them from our other businesses. Consequently, we assign them their own section in this letter and split out their combined financial statistics in our GAAP balance sheet and income statement.

A key characteristic of both companies is their huge investment in very long-lived, regulated assets, with these partially funded by large amounts of long-term debt that is *not* guaranteed by Berkshire. Our credit is in fact not needed because each company has earning power that even under terrible economic conditions will far exceed its interest requirements. Last year, for example, BNSF’s interest coverage was more than 8:1. (Our definition of coverage is pre-tax earnings/interest, *not* EBITDA/interest, a commonly used measure we view as seriously flawed.)

At BHE, meanwhile, two factors ensure the company’s ability to service its debt under all circumstances. The first is common to all utilities: recession-resistant earnings, which result from these companies offering an essential service on an exclusive basis. The second is enjoyed by few other utilities: a great diversity of earnings streams, which shield us from being seriously harmed by any single regulatory body. Recently, we have further broadened that base through our \$3 billion (Canadian) acquisition of AltaLink, an electric transmission system serving 85% of Alberta’s population. This multitude of profit streams, supplemented by the inherent advantage of being owned by a strong parent, has enabled BHE and its utility subsidiaries to significantly lower their cost of debt. This economic fact benefits both us *and* our customers.

Every day, our two subsidiaries power the American economy in major ways:

- BNSF carries about 15% (measured by ton-miles) of *all* inter-city freight, whether it is transported by truck, rail, water, air, or pipeline. Indeed, we move more ton-miles of goods than *anyone* else, a fact establishing BNSF as the most important artery in our economy’s circulatory system.

BNSF, like all railroads, also moves its cargo in an extraordinarily fuel-efficient and environmentally friendly way, carrying a ton of freight about 500 miles on a single gallon of diesel fuel. Trucks taking on the same job guzzle about four times as much fuel.

- BHE’s utilities serve regulated retail customers in eleven states. No utility company stretches further. In addition, we are a leader in renewables: From a standing start ten years ago, BHE now accounts for 6% of the country’s wind generation capacity and 7% of its solar generation capacity. Beyond these businesses, BHE owns two large pipelines that deliver 8% of our country’s natural gas consumption; the recently-purchased electric transmission operation in Canada; and major electric businesses in the U.K. and Philippines. And the beat goes on: We will continue to buy and build utility operations throughout the world for decades to come.

BHE can make these investments because it retains *all* of its earnings. In fact, last year the company retained more dollars of earnings – by far – than any other American electric utility. We and our regulators see this 100% retention policy as an important advantage – one almost certain to distinguish BHE from other utilities for many years to come.

When BHE completes certain renewables projects that are underway, the company’s renewables portfolio will have cost \$15 billion. In addition, we have conventional projects in the works that will also cost many billions. We relish making such commitments as long as they promise reasonable returns – and, on that front, we put a large amount of trust in future regulation.

Our confidence is justified both by our past experience and by the knowledge that society will forever need massive investments in both transportation and energy. It is in the self-interest of governments to treat capital providers in a manner that will ensure the continued flow of funds to essential projects. It is concomitantly in our self-interest to conduct our operations in a way that earns the approval of our regulators and the people they represent.

Last year we fully met this objective at BHE, just as we have in every year of our ownership. Our rates remain low, our customer satisfaction is high and our record for employee safety is among the best in the industry.

The story at BNSF, however – as I noted earlier – was not good in 2014, a year in which the railroad disappointed many of its customers. This problem occurred despite the record capital expenditures that BNSF has made in recent years, with those having far exceeded the outlays made by Union Pacific, our principal competitor.

The two railroads are of roughly equal size measured by revenues, though we carry considerably more freight (measured either by carloads or ton-miles). But our service problems exceeded Union Pacific's last year, and we lost market share as a result. Moreover, U.P.'s earnings beat ours by a record amount. Clearly, we have a lot of work to do.

We are wasting no time: As I also mentioned earlier, we will spend \$6 billion in 2015 on improving our railroad's operation. That will amount to about 26% of estimated revenues (a calculation that serves as the industry's yardstick). Outlays of this magnitude are largely unheard of among railroads. For us, this percentage compares to our average of 18% in 2009-2013 and to U.P.'s projection for the near future of 16-17%. Our huge investments will soon lead to a system with greater capacity and much better service. Improved profits should follow.

Here are the key figures for Berkshire Hathaway Energy and BNSF:

Berkshire Hathaway Energy (89.9% owned)

	<i>Earnings (in millions)</i>		
	<u>2014</u>	<u>2013</u>	<u>2012</u>
U.K. utilities .....	\$ 527	\$ 362	\$ 429
Iowa utility .....	298	230	236
Nevada utilities .....	549	—	—
PacifiCorp (primarily Oregon and Utah) .....	1,010	982	737
Gas Pipelines (Northern Natural and Kern River) .....	379	385	383
HomeServices .....	139	139	82
Other (net) .....	236	4	91
Operating earnings before corporate interest and taxes .....	3,138	2,102	1,958
Interest .....	427	296	314
Income taxes .....	616	170	172
Net earnings .....	<u>\$ 2,095</u>	<u>\$ 1,636</u>	<u>\$ 1,472</u>
Earnings applicable to Berkshire .....	<u>\$ 1,882</u>	<u>\$ 1,470</u>	<u>\$ 1,323</u>

BNSF

	<i>Earnings (in millions)</i>		
	<u>2014</u>	<u>2013</u>	<u>2012</u>
Revenues .....	\$23,239	\$22,014	\$20,835
Operating expenses .....	16,237	15,357	14,835
Operating earnings before interest and taxes .....	7,002	6,657	6,000
Interest (net) .....	833	729	623
Income taxes .....	2,300	2,135	2,005
Net earnings .....	<u>\$ 3,869</u>	<u>\$ 3,793</u>	<u>\$ 3,372</u>

## Manufacturing, Service and Retailing Operations

Our activities in this part of Berkshire cover the waterfront. Let's look, though, at a summary balance sheet and earnings statement for the entire group.

### Balance Sheet 12/31/14 (in millions)

<u>Assets</u>		<u>Liabilities and Equity</u>	
Cash and equivalents .....	\$ 5,765	Notes payable .....	\$ 965
Accounts and notes receivable .....	8,264	Other current liabilities .....	9,734
Inventory .....	10,236	Total current liabilities .....	10,699
Other current assets .....	1,117		
Total current assets .....	25,382		
Goodwill and other intangibles .....	28,107	Deferred taxes .....	3,801
Fixed assets .....	13,806	Term debt and other liabilities .....	4,269
Other assets .....	3,793	Non-controlling interests .....	492
	<u>\$71,088</u>	Berkshire equity .....	51,827
			<u>\$71,088</u>

### Earnings Statement (in millions)

	<u>2014</u>	<u>2013*</u>	<u>2012*</u>
Revenues .....	\$97,689	\$93,472	\$81,432
Operating expenses .....	90,788	87,208	75,734
Interest expense .....	109	104	112
Pre-tax earnings .....	6,792	6,160	5,586
Income taxes and non-controlling interests .....	2,324	2,283	2,229
Net earnings .....	<u>\$ 4,468</u>	<u>\$ 3,877</u>	<u>\$ 3,357</u>

\*Earnings for 2012 and 2013 have been restated to exclude Marmon's leasing operations, which are now included in the Finance and Financial Products section.

Our income and expense data conforming to GAAP is on page 49. In contrast, the operating expense figures above are non-GAAP and exclude some purchase-accounting items (primarily the amortization of certain intangible assets). We present the data in this manner because Charlie and I believe the adjusted numbers more accurately reflect the true economic expenses and profits of the businesses aggregated in the table than do GAAP figures.

I won't explain all of the adjustments – some are tiny and arcane – but serious investors should understand the disparate nature of intangible assets. Some truly deplete over time, while others *in no way* lose value. For software, as a big example, amortization charges are very real expenses. The concept of making charges against other intangibles, such as the amortization of customer relationships, however, arises through purchase-accounting rules and clearly does not reflect reality. GAAP accounting draws no distinction between the two types of charges. Both, that is, are recorded as expenses when earnings are calculated – even though from an investor's viewpoint they could not be more different.

In the GAAP-compliant figures we show on page 49, amortization charges of \$1.15 billion have been deducted as expenses. We would call about 20% of these “real,” the rest not. The “non-real” charges, once non-existent at Berkshire, have become significant because of the many acquisitions we have made. Non-real amortization charges will almost certainly rise further as we acquire more companies.

The GAAP-compliant table on page 67 gives you the current status of our intangible assets. We now have \$7.4 billion left to amortize, of which \$4.1 billion will be charged over the next five years. Eventually, of course, every dollar of non-real costs becomes entirely charged off. When that happens, reported earnings increase even if true earnings are flat.

Depreciation charges, we want to emphasize, are different: Every dime of depreciation expense we report is a real cost. That’s true, moreover, at most other companies. When CEOs tout EBITDA as a valuation guide, wire them up for a polygraph test.

Our public reports of earnings will, of course, continue to conform to GAAP. To embrace reality, however, you should remember to add back most of the amortization charges we report.

\* \* \* \* \*

To get back to our many manufacturing, service and retailing operations, they sell products ranging from lollipops to jet airplanes. Some of this sector’s businesses, measured by earnings on unleveraged net *tangible* assets, enjoy terrific economics, producing profits that run from 25% after-tax to far more than 100%. Others generate good returns in the area of 12% to 20%. A few, however, have very poor returns, the result of some serious mistakes I made in my job of capital allocation. I was not misled: I simply was wrong in my evaluation of the economic dynamics of the company or the industry in which it operates.

Fortunately, my blunders normally involved relatively small acquisitions. Our large buys have generally worked out well and, in a few cases, more than well. I have not, nonetheless, made my last mistake in purchasing either businesses or stocks. Not everything works out as planned.

Viewed as a single entity, the companies in this group are an excellent business. They employed an average of \$24 billion of net tangible assets during 2014 and, despite their holding large quantities of excess cash and using little leverage, earned 18.7% after-tax on that capital.

Of course, a business with terrific economics can be a bad investment if it is bought for too high a price. We have paid substantial premiums to net tangible assets for most of our businesses, a cost that is reflected in the large figure we show for goodwill. Overall, however, we are getting a decent return on the capital we have deployed in this sector. Furthermore, the intrinsic value of these businesses, in aggregate, exceeds their carrying value by a good margin, and that premium is likely to widen. Even so, the difference between intrinsic value and carrying value in both the insurance and regulated-industry segments is *far* greater. It is there that the truly big winners reside.

\* \* \* \* \*

We have far too many companies in this group to comment on them individually. Moreover, their competitors – both current and potential – read this report. In a few of our businesses we might be disadvantaged if others knew our numbers. In some of our operations that are not of a size material to an evaluation of Berkshire, therefore, we only disclose what is required. You can find a good bit of detail about many of our operations, however, on pages 97-100.



## Finance and Financial Products

This year we include in this section Marmon's very sizable leasing operations, whose wares are railcars, containers and cranes. We have also restated the previous two years to reflect that change. Why have we made it? At one time there was a large minority ownership at Marmon, and I felt it was more understandable to include all of the company's operations in one place. Today we own virtually 100% of Marmon, which makes me think you will gain more insight into our various businesses if we include Marmon's leasing operations under this heading. (The figures for the many dozens of Marmon's other businesses remain in the previous section.)

Our other leasing and rental operations are conducted by CORT (furniture) and XTRA (semi-trailers). These companies are industry leaders and have substantially increased their earnings as the American economy has gained strength. Both companies have invested more money in new equipment than have many of their competitors, and that's paying off.

Kevin Clayton has again delivered an industry-leading performance at Clayton Homes, the largest home builder in America. Last year, Clayton sold 30,871 homes, about 45% of the manufactured homes bought by Americans. When we purchased Clayton in 2003 for \$1.7 billion, its share was 14%.

Key to Clayton's earnings is the company's \$13 billion mortgage portfolio. During the financial panic of 2008 and 2009, when funding for the industry dried up, Clayton was able to keep lending because of Berkshire's backing. In fact, we continued during that period to finance our competitors' retail sales as well as our own.

Many of Clayton's borrowers have low incomes and mediocre FICO scores. But thanks to the company's sensible lending practices, its portfolio performed well during the recession, meaning a very high percentage of our borrowers kept their homes. Our blue-collar borrowers, in many cases, proved much better credit risks than their higher-income brethren.

At Marmon's railroad-car operation, lease rates have improved substantially over the past few years. The nature of this business, however, is that only 20% or so of our leases expire annually. Consequently, improved pricing only gradually works its way into our revenue stream. The trend, though, is strong. Our 105,000-car fleet consists largely of tank cars, but only 8% of those transport crude oil.

One further fact about our rail operation is important for you to know: Unlike many other lessors, we manufacture our own tank cars, about 6,000 of them in a good year. We do not book *any* profit when we transfer cars from our manufacturing division to our leasing division. Our fleet is consequently placed on our books at a "bargain" price. The difference between that figure and a "retail" price is only slowly reflected in our earnings through smaller annual depreciation charges that we enjoy over the 30-year life of the car. Because of that fact as well as others, Marmon's rail fleet is worth considerably more than the \$5 billion figure at which it is carried on our books.

Here's the earnings recap for this sector:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
		<u>(in millions)</u>	
Berkadia (our 50% share) .....	\$ 122	\$ 80	\$ 35
Clayton .....	558	416	255
CORT .....	36	40	42
Marmon – Containers and Cranes .....	238	226	246
Marmon – Railcars .....	442	353	299
XTRA .....	147	125	106
Net financial income* .....	296	324	410
	<u>\$ 1,839</u>	<u>\$ 1,564</u>	<u>\$ 1,393</u>

\* Excludes capital gains or losses

## Investments

Below we list our fifteen common stock investments that at yearend had the largest market value.

		Percentage of	12/31/14	
<u>Shares**</u>	<u>Company</u>	<u>Company</u>	<u>Cost*</u>	<u>Market</u>
		<u>Owned</u>	(in millions)	
151,610,700	American Express Company .....	14.8	\$ 1,287	\$ 14,106
400,000,000	The Coca-Cola Company .....	9.2	1,299	16,888
18,513,482	DaVita HealthCare Partners Inc. ....	8.6	843	1,402
15,430,586	Deere & Company .....	4.5	1,253	1,365
24,617,939	DIRECTV .....	4.9	1,454	2,134
13,062,594	The Goldman Sachs Group, Inc. ....	3.0	750	2,532
76,971,817	International Business Machines Corp. ....	7.8	13,157	12,349
24,669,778	Moody's Corporation .....	12.1	248	2,364
20,060,390	Munich Re .....	11.8	2,990	4,023
52,477,678	The Procter & Gamble Company .....	1.9	336	4,683 ***
22,169,930	Sanofi .....	1.7	1,721	2,032
96,890,665	U.S. Bancorp .....	5.4	3,033	4,355
43,387,980	USG Corporation .....	30.0	836	1,214
67,707,544	Wal-Mart Stores, Inc. ....	2.1	3,798	5,815
483,470,853	Wells Fargo & Company .....	9.4	11,871	26,504
	Others .....		10,180	15,704
	Total Common Stocks Carried at Market ...		<u>\$55,056</u>	<u>\$ 117,470</u>

\*This is our actual purchase price and also our tax basis; GAAP “cost” differs in a few cases because of write-ups or write-downs that have been required under GAAP rules.

\*\*Excludes shares held by pension funds of Berkshire subsidiaries.

\*\*\*Held under contract of sale for this amount.

Berkshire has one major equity position that is not included in the table: We can buy 700 million shares of Bank of America at any time prior to September 2021 for \$5 billion. At yearend these shares were worth \$12.5 billion. We are likely to purchase the shares just before expiration of our option. In the meantime, it is important for you to realize that Bank of America is, in effect, our fourth largest equity investment – and one we value highly.

\* \* \* \* \*

Attentive readers will notice that Tesco, which last year appeared in the list of our largest common stock investments, is now absent. An attentive *investor*, I’m embarrassed to report, would have sold Tesco shares earlier. I made a big mistake with this investment by dawdling.

At the end of 2012 we owned 415 million shares of Tesco, then and now the leading food retailer in the U.K. and an important grocer in other countries as well. Our cost for this investment was \$2.3 billion, and the market value was a similar amount.

In 2013, I soured somewhat on the company's then-management and sold 114 million shares, realizing a profit of \$43 million. My leisurely pace in making sales would prove expensive. Charlie calls this sort of behavior "thumb-sucking." (Considering what my delay cost us, he is being kind.)

During 2014, Tesco's problems worsened by the month. The company's market share fell, its margins contracted and accounting problems surfaced. In the world of business, bad news often surfaces serially: You see a cockroach in your kitchen; as the days go by, you meet his relatives.

We sold Tesco shares throughout the year and are now out of the position. (The company, we should mention, has hired new management, and we wish them well.) Our after-tax loss from this investment was \$444 million, about 1/5 of 1% of Berkshire's net worth. In the past 50 years, we have only once realized an investment loss that at the time of sale cost us 2% of our net worth. Twice, we experienced 1% losses. All three of these losses occurred in the 1974-1975 period, when we sold stocks that were very cheap in order to buy others we believed to be even cheaper.

\* \* \* \* \*

Our investment results have been helped by a terrific tailwind. During the 1964-2014 period, the S&P 500 rose from 84 to 2,059, which, with reinvested dividends, generated the overall return of 11,196% shown on page 2. Concurrently, the purchasing power of the dollar declined a staggering 87%. That decrease means that it now takes \$1 to buy what could be bought for 13¢ in 1965 (as measured by the Consumer Price Index).

There is an important message for investors in that disparate performance between stocks and dollars. Think back to our 2011 annual report, in which we defined investing as "the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – *after taxes have been paid on nominal gains* – in the future."

The unconventional, but inescapable, conclusion to be drawn from the past fifty years is that it has been *far* safer to invest in a diversified collection of American businesses than to invest in securities – Treasuries, for example – whose values have been tied to American currency. That was also true in the preceding half-century, a period including the Great Depression and two world wars. Investors should heed this history. To one degree or another it is almost certain to be repeated during the next century.

Stock prices will always be far more *volatile* than cash-equivalent holdings. *Over the long term*, however, currency-denominated instruments are *riskier* investments – *far* riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is *far* from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray.

It is true, of course, that owning equities for a day or a week or a year is far riskier (in both nominal and purchasing-power terms) than leaving funds in cash-equivalents. That is relevant to certain investors – say, investment banks – whose viability can be threatened by declines in asset prices and which might be forced to sell securities during depressed markets. Additionally, any party that might have meaningful near-term needs for funds should keep appropriate sums in Treasuries or insured bank deposits.

For the great majority of investors, however, who can – and *should* – invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, *bought over time*, will prove far less risky than dollar-based securities.

If the investor, instead, fears price volatility, erroneously viewing it as a measure of risk, he may, ironically, end up doing some very risky things. Recall, if you will, the pundits who six years ago bemoaned falling stock prices and advised investing in “safe” Treasury bills or bank certificates of deposit. People who heeded this sermon are now earning a pittance on sums they had previously expected would finance a pleasant retirement. (The S&P 500 was then below 700; now it is about 2,100.) If not for their fear of meaningless price volatility, these investors could have assured themselves of a good income for life by simply buying a very low-cost index fund whose dividends would trend upward over the years and whose principal would grow as well (with many ups and downs, to be sure).

Investors, of course, can, *by their own behavior*, make stock ownership highly risky. And many do. Active trading, attempts to “time” market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. Indeed, borrowed money has *no* place in the investor’s tool kit: *Anything* can happen *anytime* in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet.

The commission of the investment sins listed above is not limited to “the little guy.” Huge institutional investors, viewed as a group, have long underperformed the unsophisticated index-fund investor who simply sits tight for decades. A major reason has been fees: Many institutions pay substantial sums to consultants who, in turn, recommend high-fee managers. And that is a fool’s game.

There are a few investment managers, of course, who are very good – though in the short run, it’s difficult to determine whether a great record is due to luck or talent. Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship. Rather than listen to their siren songs, investors – large and small – should instead read Jack Bogle’s *The Little Book of Common Sense Investing*.

Decades ago, Ben Graham pinpointed the blame for investment failure, using a quote from Shakespeare: “The fault, dear Brutus, is not in our stars, but in ourselves.”

## **The Annual Meeting**

The annual meeting will be held on Saturday, May 2<sup>nd</sup> at the CenturyLink Center. Last year’s attendance of 39,000 set a record, and we expect a further increase this year as we celebrate our Golden Anniversary. Be there when the doors open at 7 a.m.

Berkshire’s talented Carrie Sova will again be in charge. Carrie joined us six years ago at the age of 24 as a secretary. Then, four years ago, I asked her to take charge of the meeting – a huge undertaking, requiring a multitude of skills – and she jumped at the chance. Carrie is unflappable, ingenious and expert at bringing out the best in the hundreds who work with her. She is aided by our entire home office crew who enjoy pitching in to make the weekend fun and informative for our owners.

And, yes, we also try to sell our visiting shareholders our products while they’re here. In fact, this year we will substantially increase the hours available for purchases, opening for business at the CenturyLink on Friday, May 1<sup>st</sup>, from noon to 5 p.m. as well as the usual 7 a.m. to 4 p.m. on meeting day. So bring a smile to Charlie’s face and do some serious shopping.

Get up early on Saturday morning. At 6:20 a.m., Norman and Jake, two Texas longhorns each weighing about a ton, will proceed down 10<sup>th</sup> Street to the CenturyLink. Aboard them will be a couple of our Justin Boot executives, who do double duty as cowboys. Following the steers will be four horses pulling a Wells Fargo stagecoach. Berkshire already markets planes, trains and automobiles. Adding steers and stagecoaches to our portfolio should seal our reputation as America’s all-purpose transportation company.

At about 7:30 a.m. on Saturday, we will have our fourth International Newspaper Tossing Challenge. Our target again will be a Clayton Home porch, located precisely 35 feet from the throwing line. When I was a teenager – in my one brief flirtation with honest labor – I tossed about 500,000 papers. So I think I’m pretty good. Challenge me! Humiliate me! Knock me down a peg! I’ll buy a Dilly Bar for anyone who lands his or her throw closer to the doorstep than I do. The papers will run 36 to 42 pages, and you must fold them yourself (no rubber bands allowed). I’ll present a special prize to the 12-or-under contestant who makes the best toss. Deb Bosanek will be the judge.

At 8:30 a.m., a new Berkshire movie will be shown. An hour later, we will start the question-and-answer period, which (with a break for lunch at CenturyLink’s stands) will last until 3:30 p.m. After a short recess, Charlie and I will convene the annual meeting at 3:45 p.m. This business session typically lasts only a half hour or so.

Your venue for shopping will be the 194,300-square-foot hall that adjoins the meeting and in which products from dozens of Berkshire subsidiaries will be for sale. If you don’t get your shopping done on Friday, slip out while Charlie’s talking on Saturday and binge on our bargains. Check the terrific BNSF railroad layout also. Even though I’m 84, it still excites me.

Last year you did your part as a shopper, and most of our businesses racked up record sales. In a nine-hour period on Saturday, we sold 1,385 pairs of Justin boots (that’s a pair every 23 seconds), 13,440 pounds of See’s candy, 7,276 pairs of Wells Lamont work gloves and 10,000 bottles of Heinz ketchup. Heinz has a new mustard product, so both mustard and ketchup will be available this year. (Buy both!) Now that we are open for business on Friday as well, we expect new records in every precinct.

Brooks, our running-shoe company, will again have a special commemorative shoe to offer at the meeting. After you purchase a pair, wear them the next day at our third annual “Berkshire 5K,” an 8 a.m. race starting at the CenturyLink. Full details for participating will be included in the Visitor’s Guide that will be sent to you with your credentials for the meeting. Entrants in the race will find themselves running alongside many of Berkshire’s managers, directors and associates. (Charlie and I, however, will sleep in.)

A GEICO booth in the shopping area will be staffed by a number of the company’s top counselors from around the country. Stop by for a quote. In most cases, GEICO will be able to give you a shareholder discount (usually 8%). This special offer is permitted by 44 of the 51 jurisdictions in which we operate. (One supplemental point: The discount is not additive if you qualify for another discount, such as that available to certain groups.) Bring the details of your existing insurance and check out our price. We can save many of you real money.

Be sure to visit the Bookworm. It will carry about 35 books and DVDs, among them a couple of new titles. Last year, many shareholders purchased Max Olson’s compilation of Berkshire letters going back to 1965, and he has produced an updated edition for the meeting. We also expect to be selling an inexpensive book commemorating our fifty years. It’s currently a work in process, but I expect it to contain a wide variety of historical material, including documents from the 19<sup>th</sup> Century.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to both the meeting and other events. Airlines have sometimes jacked up prices for the Berkshire weekend. If you are coming from far away, compare the cost of flying to Kansas City vs. Omaha. The drive between the two cities is about 2½ hours, and it may be that Kansas City can save you significant money, particularly if you had planned to rent a car in Omaha. The savings for a couple could run to \$1,000 or more. Spend that money with us.

At Nebraska Furniture Mart, located on a 77-acre site on 72<sup>nd</sup> Street between Dodge and Pacific, we will again be having “Berkshire Weekend” discount pricing. Last year in the week surrounding the meeting, the store did a record \$40,481,817 of business. (An average week for NFM’s Omaha store is about \$9 million.)

To obtain the Berkshire discount at NFM, you must make your purchases between Tuesday, April 28<sup>th</sup> and Monday, May 4<sup>th</sup> inclusive, and also present your meeting credential. The period's special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but which, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Friday, 10 a.m. to 9:30 p.m. on Saturday and 10 a.m. to 8 p.m. on Sunday. From 5:30 p.m. to 8 p.m. on Saturday, NFM is having a picnic to which you are all invited.

At Borsheims, we will again have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 9 p.m. on Friday, May 1<sup>st</sup>. The second, the main gala, will be held on Sunday, May 3<sup>rd</sup>, from 9 a.m. to 4 p.m. On Saturday, we will remain open until 6 p.m. In recent years, our three-day volume has far exceeded our sales in all of December, normally a jeweler's best month.

We will have huge crowds at Borsheims throughout the weekend. For your convenience, therefore, shareholder prices will be available from Monday, April 27<sup>th</sup> through Saturday, May 9<sup>th</sup>. During that period, please identify yourself as a shareholder by presenting your meeting credentials or a brokerage statement that shows you are a Berkshire holder.

On Sunday, in the mall outside of Borsheims, Norman Beck, a remarkable magician from Dallas, will bewilder onlookers. Additionally, we will have Bob Hamman and Sharon Osberg, two of the world's top bridge experts, available to play bridge with our shareholders on Sunday afternoon. Don't play them for money.

My friend, Ariel Hsing, will be in the mall as well on Sunday, taking on challengers at table tennis. I met Ariel when she was nine and even then I was unable to score a point against her. Now, she's a sophomore at Princeton, having already represented the United States in the 2012 Olympics. If you don't mind embarrassing yourself, test your skills against her, beginning at 1 p.m. Bill Gates and I will lead off and try to soften her up.

Gorat's and Piccolo's will again be open exclusively for Berkshire shareholders on Sunday, May 3<sup>rd</sup>. Both will be serving until 10 p.m., with Gorat's opening at 1 p.m. and Piccolo's opening at 4 p.m. These restaurants are my favorites, and I will eat at both of them on Sunday evening. Remember: To make a reservation at Gorat's, call 402-551-3733 on April 1<sup>st</sup> (*but not before*); for Piccolo's, call 402-346-2865. At Piccolo's, order a giant root beer float for dessert. Only sissies get the small one.

We will again have the same three financial journalists lead the question-and-answer period at the meeting, asking Charlie and me questions that shareholders have submitted to them by e-mail. The journalists and their e-mail addresses are: Carol Loomis, who retired last year after sixty years at Fortune, but remains *the* expert on business and financial matters, and who may be e-mailed at [loomisbrk@gmail.com](mailto:loomisbrk@gmail.com); Becky Quick, of CNBC, at [BerkshireQuestions@cnbc.com](mailto:BerkshireQuestions@cnbc.com); and Andrew Ross Sorkin, of The New York Times, at [arsorkin@nytimes.com](mailto:arsorkin@nytimes.com).

From the questions submitted, each journalist will choose the six he or she decides are the most interesting and important. The journalists have told me your question has the best chance of being selected if you keep it concise, avoid sending it in at the last moment, make it Berkshire-related and include no more than two questions in any e-mail you send them. (In your e-mail, let the journalist know if you would like your name mentioned if your question is asked.)

We will also have a panel of three analysts who follow Berkshire. This year the insurance specialist will be Gary Ransom of Dowling & Partners. Questions that deal with our non-insurance operations will come from Jonathan Brandt of Ruane, Cunniff & Goldfarb and Gregg Warren of Morningstar. Our hope is that the analysts and journalists will ask questions that add to our owners' understanding and knowledge of their investment.



Neither Charlie nor I will get so much as a clue about the questions headed our way. Some will be tough, for sure, and that's the way we like it. All told we expect at least 54 questions, which will allow for six from each analyst and journalist and for 18 from the audience. (Last year we had 62 in total.) The questioners from the audience will be chosen by means of 11 drawings that will take place at 8:15 a.m. on the morning of the annual meeting. Each of the 11 microphones installed in the arena and main overflow room will host, so to speak, a drawing.

While I'm on the subject of our owners' gaining knowledge, let me remind you that Charlie and I believe all shareholders should simultaneously have access to new information that Berkshire releases and should also have adequate time to analyze it. That's why we try to issue financial data late on Fridays or early on Saturdays and why our annual meeting is always held on a Saturday. We do not talk one-on-one to large institutional investors or analysts, treating them instead as we do all other shareholders.

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We get terrific help at meeting time from literally thousands of Omaha residents and businesses who want you to enjoy yourselves. This year, because we expect record attendance, we have worried about a shortage of hotel rooms. To deal with that possible problem, Airbnb is making a special effort to obtain listings for the period around meeting time and is likely to have a wide array of accommodations to offer. Airbnb's services may be especially helpful to shareholders who expect to spend only a single night in Omaha and are aware that last year a few hotels required guests to pay for a minimum of three nights. That gets expensive. Those people on a tight budget should check the Airbnb website.

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For good reason, I regularly extol the accomplishments of our operating managers. They are truly All-Stars who run their businesses as if they were the only asset owned by their families. I believe the mindset of our managers also to be as shareholder-oriented as can be found in the universe of large publicly-owned companies. Most of our managers have no financial need to work. The joy of hitting business "home runs" means as much to them as their paycheck.

Equally important, however, are the 24 men and women who work with me at our corporate office. This group efficiently deals with a multitude of SEC and other regulatory requirements, files a 24,100-page Federal income tax return and oversees the filing of 3,400 state tax returns, responds to countless shareholder and media inquiries, gets out the annual report, prepares for the country's largest annual meeting, coordinates the Board's activities – and the list goes on and on.

They handle all of these business tasks cheerfully and with unbelievable efficiency, making my life easy and pleasant. Their efforts go beyond activities strictly related to Berkshire: Last year they dealt with the 40 universities (selected from 200 applicants) who sent students to Omaha for a Q&A day with me. They also handle all kinds of requests that I receive, arrange my travel, and even get me hamburgers and french fries (smothered in Heinz ketchup, of course) for lunch. No CEO has it better; I truly do feel like tap dancing to work every day.

Last year, for the annual report, we dropped our 48-year-old "no pictures" policy – who says I'm not flexible? – and ran a photo of our remarkable home-office crew that was taken at our Christmas lunch. I didn't warn the gang of the public exposure they were to receive, so they didn't have on their Sunday best. This year was a different story: On the facing page you will see what our group looks like when they think someone will be noticing. However they dress, their performance is mind-boggling.

Come meet them on May 2<sup>nd</sup> and enjoy our Woodstock for Capitalists.

February 27, 2015

Warren E. Buffett  
Chairman of the Board

**BERKSHIRE HATHAWAY INC.**  
**ACQUISITION CRITERIA**

We are eager to hear *from principals or their representatives* about businesses that meet all of the following criteria:

- (1) Large purchases (at least \$75 million of pre-tax earnings unless the business will fit into one of our existing units),
- (2) Demonstrated consistent earning power (future projections are of no interest to us, nor are “turnaround” situations),
- (3) Businesses earning good returns on equity while employing little or no debt,
- (4) Management in place (we can’t supply it),
- (5) Simple businesses (if there’s lots of technology, we won’t understand it),
- (6) An offering price (we don’t want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

The larger the company, the greater will be our interest: We would like to make an acquisition in the \$5-20 billion range. *We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.*

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer – customarily within five minutes – as to whether we’re interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give. *We don’t participate in auctions.*

Charlie and I frequently get approached about acquisitions that don’t come close to meeting our tests: We’ve found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: “When the phone don’t ring, you’ll know it’s me.”



## **Berkshire – Past, Present and Future**

### **In the Beginning**

On May 6, 1964, Berkshire Hathaway, then run by a man named Seabury Stanton, sent a letter to its shareholders offering to buy 225,000 shares of its stock for \$11.375 per share. I had expected the letter; I was surprised by the price.

Berkshire then had 1,583,680 shares outstanding. About 7% of these were owned by Buffett Partnership Ltd. (“BPL”), an investing entity that I managed and in which I had virtually all of my net worth. Shortly before the tender offer was mailed, Stanton had asked me at what price BPL would sell its holdings. I answered \$11.50, and he said, “Fine, we have a deal.” Then came Berkshire’s letter, offering an eighth of a point less. I bristled at Stanton’s behavior and didn’t tender.

That was a monumentally stupid decision.

Berkshire was then a northern textile manufacturer mired in a terrible business. The industry in which it operated was heading south, both metaphorically and physically. And Berkshire, for a variety of reasons, was unable to change course.

That was true even though the industry’s problems had long been widely understood. Berkshire’s own Board minutes of July 29, 1954, laid out the grim facts: “The textile industry in New England started going out of business forty years ago. During the war years this trend was stopped. The trend must continue until supply and demand have been balanced.”

About a year after that board meeting, Berkshire Fine Spinning Associates and Hathaway Manufacturing – both with roots in the 19<sup>th</sup> Century – joined forces, taking the name we bear today. With its fourteen plants and 10,000 employees, the merged company became the giant of New England textiles. What the two managements viewed as a merger agreement, however, soon morphed into a suicide pact. During the seven years following the consolidation, Berkshire operated at an overall loss, and its net worth shrunk by 37%.

Meanwhile, the company closed nine plants, sometimes using the liquidation proceeds to repurchase shares. And that pattern caught my attention.

I purchased BPL’s first shares of Berkshire in December 1962, anticipating more closings and more repurchases. The stock was then selling for \$7.50, a wide discount from per-share working capital of \$10.25 and book value of \$20.20. Buying the stock at that price was like picking up a discarded cigar butt that had one puff remaining in it. Though the stub might be ugly and soggy, the puff would be free. Once that momentary pleasure was enjoyed, however, no more could be expected.

Berkshire thereafter stuck to the script: It soon closed another two plants, and in that May 1964 move, set out to repurchase shares with the shutdown proceeds. The price that Stanton offered was 50% above the cost of our original purchases. There it was – my free puff, just waiting for me, after which I could look elsewhere for other discarded butts.

Instead, irritated by Stanton’s chiseling, I ignored his offer and began to aggressively buy more Berkshire shares.

By April 1965, BPL owned 392,633 shares (out of 1,017,547 then outstanding) and at an early-May board meeting we formally took control of the company. Through Seabury's and my childish behavior – after all, what was an eighth of a point to either of us? – he lost his job, and I found myself with more than 25% of BPL's capital invested in a terrible business about which I knew very little. I became the dog who caught the car.

Because of Berkshire's operating losses and share repurchases, its net worth at the end of fiscal 1964 had fallen to \$22 million from \$55 million at the time of the 1955 merger. The full \$22 million was required by the textile operation: The company had no excess cash and owed its bank \$2.5 million. (Berkshire's 1964 annual report is reproduced on pages 130-142.)

For a time I got lucky: Berkshire immediately enjoyed two years of good operating conditions. Better yet, its earnings in those years were free of income tax because it possessed a large loss carry-forward that had arisen from the disastrous results in earlier years.

Then the honeymoon ended. During the 18 years following 1966, we struggled unrelentingly with the textile business, all to no avail. But stubbornness – stupidity? – has its limits. In 1985, I finally threw in the towel and closed the operation.

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Undeterred by my first mistake of committing much of BPL's resources to a dying business, I quickly compounded the error. Indeed, my second blunder was far more serious than the first, eventually becoming the most costly in my career.

Early in 1967, I had Berkshire pay \$8.6 million to buy National Indemnity Company ("NICO"), a small but promising Omaha-based insurer. (A tiny sister company was also included in the deal.) Insurance was in my sweet spot: I understood and liked the industry.

Jack Ringwalt, the owner of NICO, was a long-time friend who wanted to sell to me – me, personally. In no way was his offer intended for Berkshire. So why did I purchase NICO for Berkshire rather than for BPL? I've had 48 years to think about that question, and I've yet to come up with a good answer. I simply made a colossal mistake.

If BPL had been the purchaser, my partners and I would have owned 100% of a fine business, destined to form the base for building the company Berkshire has become. Moreover, our growth would not have been impeded for nearly two decades by the unproductive funds imprisoned in the textile operation. Finally, our subsequent acquisitions would have been owned in their entirety by my partners and me rather than being 39%-owned by the legacy shareholders of Berkshire, to whom we had no obligation. Despite these facts staring me in the face, I opted to marry 100% of an excellent business (NICO) to a 61%-owned terrible business (Berkshire Hathaway), a decision that eventually diverted \$100 billion or so from BPL partners to a collection of strangers.

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One more confession and then I'll go on to more pleasant topics: Can you believe that in 1975 I bought Waumbec Mills, another New England textile company? Of course, the purchase price was a "bargain" based on the assets we received and the *projected* synergies with Berkshire's existing textile business. Nevertheless – surprise, surprise – Waumbec was a disaster, with the mill having to be closed down not many years later.

And now some good news: The northern textile industry is finally extinct. You need no longer panic if you hear that I've been spotted wandering around New England.

## Charlie Straightens Me Out

My cigar-butt strategy worked very well while I was managing small sums. Indeed, the many dozens of free puffs I obtained in the 1950s made that decade by far the best of my life for both relative and absolute investment performance.

Even then, however, I made a few exceptions to cigar butts, the most important being GEICO. Thanks to a 1951 conversation I had with Lorimer Davidson, a wonderful man who later became CEO of the company, I learned that GEICO was a terrific business and promptly put 65% of my \$9,800 net worth into its shares. Most of my gains in those early years, though, came from investments in mediocre companies that traded at bargain prices. Ben Graham had taught me that technique, and it worked.

But a major weakness in this approach gradually became apparent: Cigar-butt investing was scalable only to a point. With large sums, it would never work well.

In addition, though marginal businesses purchased at cheap prices may be attractive as short-term investments, they are the wrong foundation on which to build a large and enduring enterprise. Selecting a marriage partner clearly requires more demanding criteria than does dating. (Berkshire, it should be noted, would have been a highly satisfactory “date”: If we had taken Seabury Stanton’s \$11.375 offer for our shares, BPL’s weighted annual return on its Berkshire investment would have been about 40%.)

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It took Charlie Munger to break my cigar-butt habits and set the course for building a business that could combine huge size with satisfactory profits. Charlie had grown up a few hundred feet from where I now live and as a youth had worked, as did I, in my grandfather’s grocery store. Nevertheless, it was 1959 before I met Charlie, long after he had left Omaha to make Los Angeles his home. I was then 28 and he was 35. The Omaha doctor who introduced us predicted that we would hit it off – and we did.

If you’ve attended our annual meetings, you know Charlie has a wide-ranging brilliance, a prodigious memory, and some firm opinions. I’m not exactly wishy-washy myself, and we sometimes don’t agree. In 56 years, however, we’ve never had an argument. When we differ, Charlie usually ends the conversation by saying: “Warren, think it over and you’ll agree with me because you’re smart and I’m right.”

What most of you do *not* know about Charlie is that architecture is among his passions. Though he began his career as a practicing lawyer (with his time billed at \$15 per hour), Charlie made his first real money in his 30s by designing and building five apartment projects near Los Angeles. Concurrently, he designed the house that he lives in today – some 55 years later. (Like me, Charlie can’t be budged if he is happy in his surroundings.) In recent years, Charlie has designed large dorm complexes at Stanford and the University of Michigan and today, at age 91, is working on another major project.

From my perspective, though, Charlie’s most important architectural feat was the design of today’s Berkshire. The blueprint he gave me was simple: Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices.

Altering my behavior is not an easy task (ask my family). I had enjoyed reasonable success without Charlie's input, so why should I listen to a lawyer who had never spent a day in business school (when – ahem – I had attended *three*). But Charlie never tired of repeating his maxims about business and investing to me, and his logic was irrefutable. Consequently, Berkshire has been built to Charlie's blueprint. My role has been that of general contractor, with the CEOs of Berkshire's subsidiaries doing the real work as sub-contractors.

The year 1972 was a turning point for Berkshire (though not without occasional backsliding on my part – remember my 1975 purchase of Waumbec). We had the opportunity then to buy See's Candy for Blue Chip Stamps, a company in which Charlie, I and Berkshire had major stakes, and which was later merged into Berkshire.

See's was a legendary West Coast manufacturer and retailer of boxed chocolates, then annually earning about \$4 million pre-tax while utilizing only \$8 million of net tangible assets. Moreover, the company had a huge asset that did not appear on its balance sheet: a broad and durable competitive advantage that gave it significant pricing power. That strength was virtually certain to give See's major gains in earnings over time. Better yet, these would materialize with only minor amounts of incremental investment. In other words, See's could be expected to gush cash for decades to come.

The family controlling See's wanted \$30 million for the business, and Charlie rightly said it was worth that much. But I didn't want to pay more than \$25 million and wasn't all that enthusiastic even at that figure. (A price that was three times net tangible assets made me gulp.) My misguided caution could have scuttled a terrific purchase. But, luckily, the sellers decided to take our \$25 million bid.

To date, See's has earned \$1.9 billion pre-tax, with its growth having required added investment of only \$40 million. See's has thus been able to distribute huge sums that have helped Berkshire buy other businesses that, in turn, have themselves produced large distributable profits. (Envision rabbits breeding.) Additionally, through watching See's in action, I gained a business education about the value of powerful brands that opened my eyes to many other profitable investments.

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Even with Charlie's blueprint, I have made plenty of mistakes since Waumbec. The most gruesome was Dexter Shoe. When we purchased the company in 1993, it had a terrific record and in no way looked to me like a cigar butt. Its competitive strengths, however, were soon to evaporate because of foreign competition. And I simply didn't see that coming.

Consequently, Berkshire paid \$433 million for Dexter and, rather promptly, its value went to zero. GAAP accounting, however, doesn't come close to recording the magnitude of my error. The fact is that I gave Berkshire stock to the sellers of Dexter rather than cash, and the shares I used for the purchase are now worth about \$5.7 billion. As a financial disaster, this one deserves a spot in the Guinness Book of World Records.

Several of my subsequent errors also involved the use of Berkshire shares to purchase businesses whose earnings were destined to simply limp along. Mistakes of that kind are deadly. Trading shares of a wonderful business – which Berkshire most certainly is – for ownership of a so-so business irreparably destroys value.

We've also suffered financially when this mistake has been committed by companies whose shares Berkshire has owned (with the errors sometimes occurring while I was serving as a director). Too often CEOs seem blind to an elementary reality: The intrinsic value of the shares you give in an acquisition must not be greater than the intrinsic value of the business you receive.



I've yet to see an investment banker quantify this all-important math when he is presenting a stock-for-stock deal to the board of a potential acquirer. Instead, the banker's focus will be on describing "customary" premiums-to-market-price that are currently being paid for acquisitions – an absolutely asinine way to evaluate the attractiveness of an acquisition – or whether the deal will increase the acquirer's earnings-per-share (which in itself should be far from determinative). In striving to achieve the desired per-share number, a panting CEO and his "helpers" will often conjure up fanciful "synergies." (As a director of 19 companies over the years, I've never heard "dis-synergies" mentioned, though I've witnessed plenty of these once deals have closed.) Post mortems of acquisitions, in which reality is honestly compared to the original projections, are rare in American boardrooms. They should instead be standard practice.

I can promise you that long after I'm gone, Berkshire's CEO and Board will carefully make intrinsic value calculations before issuing shares in any acquisitions. You can't get rich trading a hundred-dollar bill for eight tens (even if your advisor has handed you an expensive "fairness" opinion endorsing that swap).

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Overall, Berkshire's acquisitions have worked out well – and *very* well in the case of a few large ones. So, too, have our investments in marketable securities. The latter are always valued on our balance sheet at their market prices so any gains – including those unrealized – are immediately reflected in our net worth. But the businesses we buy outright are never revalued upward on our balance sheet, even when we could sell them for many billions of dollars more than their carrying value. The unrecorded gains in the value of Berkshire's subsidiaries have become huge, with these growing at a particularly fast pace in the last decade.

Listening to Charlie has paid off.

## Berkshire Today

Berkshire is now a sprawling conglomerate, constantly trying to sprawl further.

Conglomerates, it should be acknowledged, have a terrible reputation with investors. And they richly deserve it. Let me first explain why they are in the doghouse, and then I will go on to describe why the conglomerate form brings huge and enduring advantages to Berkshire.

Since I entered the business world, conglomerates have enjoyed several periods of extreme popularity, the silliest of which occurred in the late 1960s. The drill for conglomerate CEOs then was simple: By personality, promotion or dubious accounting – and often by all three – these managers drove a fledgling conglomerate's stock to, say, 20 times earnings and then issued shares as fast as possible to acquire another business selling at ten-or-so times earnings. They immediately applied "pooling" accounting to the acquisition, which – with not a dime's worth of change in the underlying businesses – automatically increased per-share earnings, and used the rise as proof of managerial genius. They next explained to investors that this sort of talent justified the maintenance, or even the enhancement, of the acquirer's p/e multiple. And, finally, they promised to endlessly repeat this procedure and thereby create ever-increasing per-share earnings.

Wall Street's love affair with this hocus-pocus intensified as the 1960s rolled by. The Street's denizens are always ready to suspend disbelief when dubious maneuvers are used to manufacture rising per-share earnings, particularly if these acrobatics produce mergers that generate huge fees for investment bankers. Auditors willingly sprinkled their holy water on the conglomerates' accounting and sometimes even made suggestions as to how to further juice the numbers. For many, gushers of easy money washed away ethical sensitivities.

Since the per-share earnings gains of an expanding conglomerate came from exploiting p/e differences, its CEO had to search for businesses selling at low multiples of earnings. These, of course, were characteristically mediocre businesses with poor long-term prospects. This incentive to bottom-fish usually led to a conglomerate's collection of underlying businesses becoming more and more junky. That mattered little to investors: It was deal velocity and pooling accounting they looked to for increased earnings.

The resulting firestorm of merger activity was fanned by an adoring press. Companies such as ITT, Litton Industries, Gulf & Western, and LTV were lionized, and their CEOs became celebrities. (These once-famous conglomerates are now long gone. As Yogi Berra said, "Every Napoleon meets his Watergate.")

Back then, accounting shenanigans of all sorts – many of them ridiculously transparent – were excused or overlooked. Indeed, having an accounting wizard at the helm of an expanding conglomerate was viewed as a huge plus: Shareholders in those instances could be sure that *reported* earnings would never disappoint, no matter how bad the operating realities of the business might become.

In the late 1960s, I attended a meeting at which an acquisitive CEO bragged of his "bold, imaginative accounting." Most of the analysts listening responded with approving nods, seeing themselves as having found a manager whose forecasts were certain to be met, whatever the business results might be.

Eventually, however, the clock struck twelve, and everything turned to pumpkins and mice. Once again, it became evident that business models based on the serial issuances of overpriced shares – just like chain-letter models – most assuredly redistribute wealth, but in no way create it. Both phenomena, nevertheless, periodically blossom in our country – they are every promoter’s dream – though often they appear in a carefully-crafted disguise. The ending is always the same: Money flows from the gullible to the fraudster. And with stocks, unlike chain letters, the sums hijacked can be staggering.

At both BPL and Berkshire, we have *never* invested in companies that are hell-bent on issuing shares. That behavior is one of the surest indicators of a promotion-minded management, weak accounting, a stock that is overpriced and – all too often – outright dishonesty.

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So what do Charlie and I find so attractive about Berkshire’s conglomerate structure? To put the case simply: If the conglomerate form is used judiciously, it is an ideal structure for maximizing long-term capital growth.

One of the heralded virtues of capitalism is that it efficiently allocates funds. The argument is that markets will direct investment to promising businesses and deny it to those destined to wither. That is true: With all its excesses, market-driven allocation of capital is usually far superior to any alternative.

Nevertheless, there are often obstacles to the rational movement of capital. As those 1954 Berkshire minutes made clear, capital withdrawals within the textile industry that should have been obvious were delayed for decades because of the vain hopes and self-interest of managements. Indeed, I myself delayed abandoning our obsolete textile mills for far too long.

A CEO with capital employed in a declining operation seldom elects to massively redeploy that capital into unrelated activities. A move of that kind would usually require that long-time associates be fired and mistakes be admitted. Moreover, it’s unlikely *that* CEO would be the manager you would wish to handle the redeployment job even if he or she was inclined to undertake it.

At the shareholder level, taxes and frictional costs weigh heavily on individual investors when they attempt to reallocate capital among businesses and industries. Even tax-free institutional investors face major costs as they move capital because they usually need intermediaries to do this job. A lot of mouths with expensive tastes then clamor to be fed – among them investment bankers, accountants, consultants, lawyers and such capital-reallocators as leveraged buyout operators. Money-shufflers don’t come cheap.

In contrast, a conglomerate such as Berkshire is perfectly positioned to allocate capital rationally and at minimal cost. Of course, form itself is no guarantee of success: We have made plenty of mistakes, and we will make more. Our structural advantages, however, are formidable.

At Berkshire, we can – without incurring taxes or much in the way of other costs – move huge sums from businesses that have limited opportunities for incremental investment to other sectors with greater promise. Moreover, we are free of historical biases created by lifelong association with a given industry and are not subject to pressures from colleagues having a vested interest in maintaining the status quo. That’s important: If horses had controlled investment decisions, there would have been no auto industry.

Another major advantage we possess is the ability to buy *pieces* of wonderful businesses – a.k.a. common stocks. That’s not a course of action open to most managements. Over our history, this strategic alternative has proved to be very helpful; a broad range of options always sharpens decision-making. The businesses we are offered by the stock market every day – in small pieces, to be sure – are often far more attractive than the businesses we are concurrently being offered in their entirety. Additionally, the gains we’ve realized from marketable securities have helped us make certain large acquisitions that would otherwise have been beyond our financial capabilities.

In effect, the world is Berkshire’s oyster – a world offering us a range of opportunities far beyond those realistically open to most companies. We are limited, of course, to businesses whose economic prospects we can evaluate. And that’s a serious limitation: Charlie and I have no idea what a great many companies will look like ten years from now. But that limitation is much smaller than that borne by an executive whose experience has been confined to a single industry. On top of that, we can profitably scale to a *far* larger size than the many businesses that are constrained by the limited potential of the single industry in which they operate.

I mentioned earlier that See’s Candy had produced huge earnings compared to its modest capital requirements. We would have loved, of course, to intelligently use those funds to expand our candy operation. But our many attempts to do so were largely futile. So, without incurring tax inefficiencies or frictional costs, we have used the excess funds generated by See’s to help purchase other businesses. If See’s had remained a stand-alone company, its earnings would have had to be distributed to investors to redeploy, sometimes after being heavily depleted by large taxes and, almost always, by significant frictional and agency costs.

\* \* \* \* \*

Berkshire has one further advantage that has become increasingly important over the years: We are now the home of choice for the owners and managers of many outstanding businesses.

Families that own successful businesses have multiple options when they contemplate sale. Frequently, the best decision is to do nothing. There are worse things in life than having a prosperous business that one understands well. But sitting tight is seldom recommended by Wall Street. (Don’t ask the barber whether you need a haircut.)

When one part of a family wishes to sell while others wish to continue, a public offering often makes sense. But, when owners wish to cash out entirely, they usually consider one of two paths.

The first is sale to a competitor who is salivating at the possibility of wringing “synergies” from the combining of the two companies. This buyer invariably contemplates getting rid of large numbers of the seller’s associates, the very people who have helped the owner build his business. A caring owner, however – and there are plenty of them – usually does not want to leave his long-time associates sadly singing the old country song: “*She got the goldmine, I got the shaft.*”

The second choice for sellers is the Wall Street buyer. For some years, these purchasers accurately called themselves “leveraged buyout firms.” When that term got a bad name in the early 1990s – remember RJR and *Barbarians at the Gate?* – these buyers hastily relabeled themselves “private-equity.”

The name may have changed but that was all: Equity is dramatically *reduced* and debt is piled on in virtually all private-equity purchases. Indeed, the amount that a private-equity purchaser offers to the seller is in part determined by the buyer assessing the *maximum* amount of debt that can be placed on the acquired company.

Later, if things go well and equity begins to build, leveraged buy-out shops will often seek to re-leverage with new borrowings. They then typically use part of the proceeds to pay a huge dividend that drives equity sharply downward, sometimes even to a negative figure.

In truth, “equity” is a dirty word for many private-equity buyers; what they love is debt. And, because debt is currently so inexpensive, these buyers can frequently pay top dollar. Later, the business will be resold, often to another leveraged buyer. In effect, the business becomes a piece of merchandise.

Berkshire offers a third choice to the business owner who wishes to sell: a permanent home, in which the company’s people and culture will be retained (though, occasionally, management changes will be needed). Beyond that, any business we acquire dramatically increases its financial strength and ability to grow. Its days of dealing with banks and Wall Street analysts are also forever ended.

Some sellers don’t care about these matters. But, when sellers do, Berkshire does not have a lot of competition.

\* \* \* \* \*

Sometimes pundits propose that Berkshire spin-off certain of its businesses. These suggestions make no sense. Our companies are worth more as part of Berkshire than as separate entities. One reason is our ability to move funds between businesses or into new ventures instantly and without tax. In addition, certain costs duplicate themselves, in full or part, if operations are separated. Here’s the most obvious example: Berkshire incurs nominal costs for its single board of directors; were our dozens of subsidiaries to be split off, the overall cost for directors would soar. So, too, would regulatory and administration expenditures.

Finally, there are sometimes important tax efficiencies for Subsidiary A because we own Subsidiary B. For example, certain tax credits that are available to our utilities are currently realizable only because we generate huge amounts of taxable income at other Berkshire operations. That gives Berkshire Hathaway Energy a major advantage over most public-utility companies in developing wind and solar projects.

Investment bankers, being paid as they are for action, constantly urge acquirers to pay 20% to 50% premiums over market price for publicly-held businesses. The bankers tell the buyer that the premium is justified for “control value” and for the wonderful things that are going to happen once the acquirer’s CEO takes charge. (What acquisition-hungry manager will challenge *that* assertion?)

A few years later, bankers – bearing straight faces – again appear and just as earnestly urge spinning off the earlier acquisition in order to “unlock shareholder value.” Spin-offs, of course, strip the owning company of its purported “control value” without any compensating payment. The bankers explain that the spun-off company will flourish because its management will be more entrepreneurial, having been freed from the smothering bureaucracy of the parent company. (So much for that talented CEO we met earlier.)

If the divesting company later wishes to reacquire the spun-off operation, it presumably would again be urged by its bankers to pay a hefty “control” premium for the privilege. (Mental “flexibility” of this sort by the banking fraternity has prompted the saying that fees too often lead to transactions rather than transactions leading to fees.)

It’s possible, of course, that someday a spin-off or sale at Berkshire would be required by regulators. Berkshire carried out such a spin-off in 1979, when new regulations for bank holding companies forced us to divest a bank we owned in Rockford, Illinois.

Voluntary spin-offs, though, make no sense for us: We would lose control value, capital-allocation flexibility and, in some cases, important tax advantages. The CEOs who brilliantly run our subsidiaries now would have difficulty in being as effective if running a spun-off operation, given the operating and financial advantages derived from Berkshire's ownership. Moreover, the parent and the spun-off operations, once separated, would likely incur moderately greater costs than existed when they were combined.

\* \* \* \* \*

Before I depart the subject of spin-offs, let's look at a lesson to be learned from a conglomerate mentioned earlier: LTV. I'll summarize here, but those who enjoy a good financial story should read the piece about Jimmy Ling that ran in the October 1982 issue of *D Magazine*. Look it up on the Internet.

Through a lot of corporate razzle-dazzle, Ling had taken LTV from sales of only \$36 million in 1965 to number 14 on the Fortune 500 list just two years later. Ling, it should be noted, had never displayed any managerial skills. But Charlie told me long ago to never underestimate the man who overestimates himself. And Ling had no peer in that respect.

Ling's strategy, which he labeled "project redeployment," was to buy a large company and then partially spin off its various divisions. In LTV's 1966 annual report, he explained the magic that would follow: "Most importantly, acquisitions must meet the test of the 2 plus 2 equals 5 (or 6) formula." The press, the public and Wall Street loved this sort of talk.

In 1967 Ling bought Wilson & Co., a huge meatpacker that also had interests in golf equipment and pharmaceuticals. Soon after, he split the parent into three businesses, Wilson & Co. (meatpacking), Wilson Sporting Goods and Wilson Pharmaceuticals, each of which was to be partially spun off. These companies quickly became known on Wall Street as Meatball, Golf Ball and Goof Ball.

Soon thereafter, it became clear that, like Icarus, Ling had flown too close to the sun. By the early 1970s, Ling's empire was melting, and he himself had been spun off from LTV . . . that is, *fired*.

Periodically, financial markets will become divorced from reality – you can count on that. More Jimmy Lings will appear. They will look and sound authoritative. The press will hang on their every word. Bankers will fight for their business. What they are saying will recently have "worked." Their early followers will be feeling very clever. Our suggestion: Whatever their line, never forget that 2+2 will always equal 4. And when someone tells you how old-fashioned that math is --- zip up your wallet, take a vacation and come back in a few years to buy stocks at cheap prices.

\* \* \* \* \*

Today Berkshire possesses (1) an unmatched collection of businesses, most of them now enjoying favorable economic prospects; (2) a cadre of outstanding managers who, with few exceptions, are unusually devoted to both the subsidiary they operate *and* to Berkshire; (3) an extraordinary diversity of earnings, premier financial strength and oceans of liquidity that we will maintain under *all* circumstances; (4) a first-choice ranking among many owners and managers who are contemplating sale of their businesses and (5) in a point related to the preceding item, a culture, distinctive in many ways from that of most large companies, that we have worked 50 years to develop and that is now rock-solid.

These strengths provide us a wonderful foundation on which to build.



## The Next 50 Years at Berkshire

Now let's take a look at the road ahead. Bear in mind that if I had attempted 50 years ago to gauge what was coming, certain of my predictions would have been far off the mark. With that warning, I will tell you what I would say to my family today if they asked me about Berkshire's future.

- First and definitely foremost, I believe that the chance of permanent capital loss for patient Berkshire shareholders is as low as can be found among single-company investments. That's because our per-share *intrinsic business value* is almost certain to advance over time.

This cheery prediction comes, however, with an important caution: If an investor's entry point into Berkshire stock is unusually high – at a price, say, approaching double book value, which Berkshire shares have occasionally reached – it may well be many years before the investor can realize a profit. In other words, a sound investment can morph into a rash speculation if it is bought at an elevated price. Berkshire is not exempt from this truth.

Purchases of Berkshire that investors make at a price modestly above the level at which the company would repurchase its shares, however, should produce gains within a reasonable period of time. Berkshire's directors will only authorize repurchases at a price they believe to be *well below* intrinsic value. (In our view, that is an essential criterion for repurchases that is often ignored by other managements.)

For those investors who plan to sell within a year or two after their purchase, I can offer *no* assurances, whatever the entry price. Movements of the general stock market during such abbreviated periods will likely be far more important in determining your results than the concomitant change in the intrinsic value of your Berkshire shares. As Ben Graham said many decades ago: "In the short-term the market is a voting machine; in the long-run it acts as a weighing machine." Occasionally, the voting decisions of investors – amateurs and professionals alike – border on lunacy.

Since I know of no way to reliably predict market movements, I recommend that you purchase Berkshire shares *only* if you expect to hold them for at least five years. Those who seek short-term profits should look elsewhere.

Another warning: Berkshire shares should not be purchased with borrowed money. There have been three times since 1965 when our stock has fallen about 50% from its high point. Someday, something close to this kind of drop will happen again, and no one knows when. Berkshire will almost certainly be a satisfactory holding for *investors*. But it could well be a disastrous choice for speculators employing leverage.

- I believe the chance of any event causing Berkshire to experience financial problems is essentially zero. We will always be prepared for the thousand-year flood; in fact, if it occurs we will be selling life jackets to the unprepared. Berkshire played an important role as a "first responder" during the 2008-2009 meltdown, and we have since more than doubled the strength of our balance sheet and our earnings potential. Your company is the Gibraltar of American business and will remain so.

Financial staying power requires a company to maintain three strengths under *all* circumstances: (1) a large and reliable stream of earnings; (2) massive liquid assets and (3) *no* significant near-term cash requirements. Ignoring that last necessity is what usually leads companies to experience unexpected problems: Too often, CEOs of profitable companies feel they will always be able to refund maturing obligations, however large these are. In 2008-2009, many managements learned how perilous that mindset can be.

Here's how we will *always* stand on the three essentials. First, our earnings stream is huge and comes from a vast array of businesses. Our shareholders now own many large companies that have durable competitive advantages, and we will acquire more of those in the future. Our diversification assures Berkshire's continued profitability, even if a catastrophe causes insurance losses that far exceed any previously experienced.

Next up is cash. At a healthy business, cash is sometimes thought of as something to be minimized – as an unproductive asset that acts as a drag on such markers as return on equity. Cash, though, is to a business as oxygen is to an individual: never thought about when it is present, the only thing in mind when it is absent.

American business provided a case study of that in 2008. In September of that year, many long-prosperous companies suddenly wondered whether their checks would bounce in the days ahead. Overnight, their financial oxygen disappeared.

At Berkshire, our “breathing” went uninterrupted. Indeed, in a three-week period spanning late September and early October, we supplied \$15.6 *billion* of fresh money to American businesses.

We could do that because we always maintain at least \$20 billion – and usually far more – in cash equivalents. And by that we mean U.S. Treasury bills, not other substitutes for cash that are claimed to deliver liquidity and actually do so, *except* when it is truly needed. When bills come due, only cash is legal tender. Don’t leave home without it.

Finally – getting to our third point – we will never engage in operating or investment practices that can result in sudden demands for large sums. That means we will not expose Berkshire to short-term debt maturities of size nor enter into derivative contracts or other business arrangements that could require large collateral calls.

Some years ago, we became a party to certain derivative contracts that we believed were significantly mispriced and that had only minor collateral requirements. These have proved to be quite profitable. Recently, however, newly-written derivative contracts have required full collateralization. And that ended our interest in derivatives, regardless of what profit potential they might offer. We have not, for some years, written these contracts, except for a few needed for operational purposes at our utility businesses.

Moreover, we will not write insurance contracts that give policyholders the right to cash out at their option. Many *life* insurance products contain redemption features that make them susceptible to a “run” in times of extreme panic. Contracts of that sort, however, do not exist in the property-casualty world that we inhabit. If our premium volume should shrink, our float would decline – but only at a very slow pace.

The reason for our conservatism, which may impress some people as extreme, is that it is entirely predictable that people will occasionally panic, but not at all predictable when this will happen. Though practically all days are relatively uneventful, tomorrow is *always* uncertain. (I felt no special apprehension on December 6, 1941 or September 10, 2001.) And if you can’t predict what tomorrow will bring, you must be prepared for whatever it does.

A CEO who is 64 and plans to retire at 65 may have his own special calculus in evaluating risks that have only a tiny chance of happening in a given year. He may, in fact, be “right” 99% of the time. Those odds, however, hold no appeal for us. We will never play financial Russian roulette with the funds you’ve entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet. In our view, it is madness to risk losing what you *need* in pursuing what you simply *desire*.

- Despite our conservatism, I think we will be able *every* year to build the underlying per-share earning power of Berkshire. That does *not* mean operating earnings will increase each year – far from it. The U.S. economy will ebb and flow – though mostly flow – and, when it weakens, so will our current earnings. But we will continue to achieve organic gains, make bolt-on acquisitions and enter new fields. I believe, therefore, that Berkshire will annually add to its *underlying* earning power.

In some years the gains will be substantial, and at other times they will be minor. Markets, competition, and chance will determine when opportunities come our way. Through it all, Berkshire will keep moving forward, powered by the array of solid businesses we now possess and the new companies we will purchase. In most years, moreover, our country’s economy will provide a strong tailwind for business. We are blessed to have the United States as our home field.

- The bad news is that Berkshire's long-term gains – measured by percentages, not by dollars – cannot be dramatic and *will not come close* to those achieved in the past 50 years. The numbers have become too big. I think Berkshire will outperform the average American company, but our advantage, if any, won't be great.

Eventually – probably between ten and twenty years from now – Berkshire's earnings and capital resources will reach a level that will not allow management to intelligently reinvest all of the company's earnings. At that time our directors will need to determine whether the best method to distribute the excess earnings is through dividends, share repurchases or both. If Berkshire shares are selling below intrinsic business value, massive repurchases will almost certainly be the best choice. You can be comfortable that your directors will make the right decision.

- No company will be more shareholder-minded than Berkshire. For more than 30 years, we have annually reaffirmed our Shareholder Principles (see page 117), always leading off with: "Although our form is corporate, our attitude is partnership." This covenant with you is etched in stone.

We have an extraordinarily knowledgeable and business-oriented board of directors ready to carry out that promise of partnership. None took the job for the money: In an arrangement almost non-existent elsewhere, our directors are paid only token fees. They receive their rewards instead through ownership of Berkshire shares and the satisfaction that comes from being good stewards of an important enterprise.

The shares that they and their families own – which, in many cases, are worth very substantial sums – were *purchased* in the market (rather than their materializing through options or grants). In addition, unlike almost all other sizable public companies, we carry no directors and officers liability insurance. At Berkshire, directors walk in your shoes.

To further ensure continuation of our culture, I have suggested that my son, Howard, succeed me as a *non-executive* Chairman. My only reason for this wish is to make change easier if the wrong CEO should ever be employed and there occurs a need for the Chairman to move forcefully. I can assure you that this problem has a *very* low probability of arising at Berkshire – likely as low as at any public company. In my service on the boards of nineteen public companies, however, I've seen how hard it is to replace a mediocre CEO if that person is also Chairman. (The deed usually gets done, but almost always very late.)

If elected, Howard will receive no pay and will spend no time at the job other than that required of all directors. He will simply be a safety valve to whom any director can go if he or she has concerns about the CEO and wishes to learn if other directors are expressing doubts as well. Should multiple directors be apprehensive, Howard's chairmanship will allow the matter to be promptly and properly addressed.

- Choosing the right CEO is all-important and is a subject that commands much time at Berkshire board meetings. Managing Berkshire is primarily a job of capital allocation, coupled with the selection and retention of outstanding managers to captain our operating subsidiaries. Obviously, the job also requires the replacement of a subsidiary's CEO when that is called for. These duties require Berkshire's CEO to be a rational, calm and decisive individual who has a broad understanding of business and good insights into human behavior. It's important as well that he knows his limits. (As Tom Watson, Sr. of IBM said, "I'm no genius, but I'm smart in spots and I stay around those spots.")

Character is crucial: A Berkshire CEO must be "all in" for the company, not for himself. (I'm using male pronouns to avoid awkward wording, but gender should never decide who becomes CEO.) He can't help but earn money far in excess of any possible need for it. But it's important that neither ego nor avarice motivate him to reach for pay matching his most lavishly-compensated peers, even if his achievements far exceed theirs. A CEO's behavior has a huge impact on managers down the line: If it's clear to them that shareholders' interests are paramount to him, they will, with few exceptions, also embrace that way of thinking.

My successor will need one other particular strength: the ability to fight off the ABCs of business decay, which are arrogance, bureaucracy and complacency. When these corporate cancers metastasize, even the strongest of companies can falter. The examples available to prove the point are legion, but to maintain friendships I will exhume only cases from the distant past.

In their glory days, General Motors, IBM, Sears Roebuck and U.S. Steel sat atop huge industries. Their strengths seemed unassailable. But the destructive behavior I deplored above eventually led each of them to fall to depths that their CEOs and directors had not long before thought impossible. Their one-time financial strength and their historical earning power proved no defense.

Only a vigilant and determined CEO can ward off such debilitating forces as Berkshire grows ever larger. He must never forget Charlie's plea: "Tell me where I'm going to die, so I'll never go there." If our non-economic values were to be lost, much of Berkshire's economic value would collapse as well. "Tone at the top" will be key to maintaining Berkshire's special culture.

Fortunately, the structure our future CEOs will need to be successful is firmly in place. The extraordinary delegation of authority now existing at Berkshire is the ideal antidote to bureaucracy. In an operating sense, Berkshire is not a giant company but rather a collection of large companies. At headquarters, we have never had a committee nor have we ever required our subsidiaries to submit budgets (though many use them as an important internal tool). We don't have a legal office nor departments that other companies take for granted: human relations, public relations, investor relations, strategy, acquisitions, you name it.

We do, of course, have an active audit function; no sense being a damned fool. To an unusual degree, however, we trust our managers to run their operations with a keen sense of stewardship. After all, they were doing exactly that before we acquired their businesses. With only occasional exceptions, furthermore, our trust produces better results than would be achieved by streams of directives, endless reviews and layers of bureaucracy. Charlie and I try to interact with our managers in a manner consistent with what we would wish for, if the positions were reversed.

- Our directors believe that our future CEOs should come from internal candidates whom the Berkshire board has grown to know well. Our directors also believe that an incoming CEO should be relatively young, so that he or she can have a long run in the job. Berkshire will operate best if its CEOs average well over ten years at the helm. (It's hard to teach a new dog old tricks.) And they are not likely to retire at 65 either (or have you noticed?).

In both Berkshire's business acquisitions and large, tailored investment moves, it is important that our counterparties be both familiar with and feel comfortable with Berkshire's CEO. Developing confidence of that sort and cementing relationships takes time. The payoff, though, can be huge.

Both the board and I believe we now have the right person to succeed me as CEO – a successor ready to assume the job the day after I die or step down. In certain important respects, this person will do a better job than I am doing.

- Investments will always be of great importance to Berkshire and will be handled by several specialists. They will report to the CEO because their investment decisions, in a broad way, will need to be coordinated with Berkshire's operating and acquisition programs. Overall, though, our investment managers will enjoy great autonomy. In this area, too, we are in fine shape for decades to come. Todd Combs and Ted Weschler, each of whom has spent several years on Berkshire's investment team, are first-rate in all respects and can be of particular help to the CEO in evaluating acquisitions.

All told, Berkshire is ideally positioned for life after Charlie and I leave the scene. We have the right people in place – the right directors, managers and prospective successors to those managers. Our culture, furthermore, is embedded throughout their ranks. Our system is also regenerative. To a large degree, both good and bad cultures self-select to perpetuate themselves. For very good reasons, business owners and operating managers with values similar to ours will continue to be attracted to Berkshire as a one-of-a-kind and *permanent* home.

- I would be remiss if I didn't salute another key constituency that makes Berkshire special: our shareholders. Berkshire truly has an owner base unlike that of any other giant corporation. That fact was demonstrated in spades at last year's annual meeting, where the shareholders were offered a proxy resolution:

RESOLVED: Whereas the corporation has more money than it needs and since the owners unlike Warren are not multi billionaires, the board shall consider paying a meaningful annual dividend on the shares.

The sponsoring shareholder of that resolution never showed up at the meeting, so his motion was not officially proposed. Nevertheless, the proxy votes had been tallied, and they were enlightening.

Not surprisingly, the A shares – owned by relatively few shareholders, each with a large economic interest – voted “no” on the dividend question by a margin of 89 to 1.

The remarkable vote was that of our B shareholders. They number in the hundreds of thousands – perhaps even totaling one million – and they voted 660,759,855 “no” and 13,927,026 “yes,” a ratio of about 47 to 1.

Our directors recommended a “no” vote but the company did not otherwise attempt to influence shareholders. Nevertheless, 98% of the shares voting said, in effect, “Don't send us a dividend but instead reinvest all of the earnings.” To have our fellow owners – large and small – be so in sync with our managerial philosophy is both remarkable and rewarding.

I am a lucky fellow to have you as partners.

Warren E. Buffett

## **Vice Chairman's Thoughts – Past and Future**

To the shareholders of Berkshire Hathaway Inc.:

I closely watched the 50-year history of Berkshire's uncommon success under Warren Buffett. And it now seems appropriate that I independently supplement whatever celebratory comment comes from him. I will try to do five things.

- (1) Describe the management system and policies that caused a small and unfixably-doomed commodity textile business to morph into the mighty Berkshire that now exists,
- (2) Explain how the management system and policies came into being,
- (3) Explain, to some extent, why Berkshire did so well,
- (4) Predict whether abnormally good results would continue if Buffett were soon to depart, and
- (5) Consider whether Berkshire's great results over the last 50 years have implications that may prove useful elsewhere.

The management system and policies of Berkshire under Buffett (herein together called "the Berkshire system") were fixed early and are described below:

- (1) Berkshire would be a diffuse conglomerate, averse only to activities about which it could not make useful predictions.
- (2) Its top company would do almost all business through separately incorporated subsidiaries whose CEOs would operate with very extreme autonomy.
- (3) There would be almost nothing at conglomerate headquarters except a tiny office suite containing a Chairman, a CFO, and a few assistants who mostly helped the CFO with auditing, internal control, etc.
- (4) Berkshire subsidiaries would always prominently include casualty insurers. Those insurers as a group would be expected to produce, in due course, dependable underwriting gains while also producing substantial "float" (from unpaid insurance liabilities) for investment.
- (5) There would be no significant system-wide personnel system, stock option system, other incentive system, retirement system, or the like, because the subsidiaries would have their own systems, often different.
- (6) Berkshire's Chairman would reserve only a few activities for himself.
  - (i) He would manage almost all security investments, with these normally residing in Berkshire's casualty insurers.
  - (ii) He would choose all CEOs of important subsidiaries, and he would fix their compensation and obtain from each a private recommendation for a successor in case one was suddenly needed.
  - (iii) He would deploy most cash not needed in subsidiaries after they had increased their competitive advantage, with the ideal deployment being the use of that cash to acquire new subsidiaries.
  - (iv) He would make himself promptly available for almost any contact wanted by any subsidiary's CEO, and he would require almost no additional contact.
  - (v) He would write a long, logical, and useful letter for inclusion in his annual report, designed as he would wish it to be if he were only a passive shareholder, and he would be available for hours of answering questions at annual shareholders' meetings.
  - (vi) He would try to be an exemplar in a culture that would work well for customers, shareholders, and other incumbents for a long time, both before and after his departure.
  - (vii) His first priority would be reservation of much time for quiet reading and thinking, particularly that which might advance his determined learning, no matter how old he became; and



- (viii) He would also spend much time in enthusiastically admiring what others were accomplishing.
- (7) New subsidiaries would usually be bought with cash, not newly issued stock.
  - (8) Berkshire would not pay dividends so long as more than one dollar of market value for shareholders was being created by each dollar of retained earnings.
  - (9) In buying a new subsidiary, Berkshire would seek to pay a fair price for a good business that the Chairman could pretty well understand. Berkshire would also want a good CEO in place, one expected to remain for a long time and to manage well without need for help from headquarters.
  - (10) In choosing CEOs of subsidiaries, Berkshire would try to secure trustworthiness, skill, energy, and love for the business and circumstances the CEO was in.
  - (11) As an important matter of preferred conduct, Berkshire would almost never sell a subsidiary.
  - (12) Berkshire would almost never transfer a subsidiary's CEO to another unrelated subsidiary.
  - (13) Berkshire would never force the CEO of a subsidiary to retire on account of mere age.
  - (14) Berkshire would have little debt outstanding as it tried to maintain (i) virtually perfect creditworthiness under all conditions and (ii) easy availability of cash and credit for deployment in times presenting unusual opportunities.
  - (15) Berkshire would always be user-friendly to a prospective seller of a large business. An offer of such a business would get prompt attention. No one but the Chairman and one or two others at Berkshire would ever know about the offer if it did not lead to a transaction. And they would never tell outsiders about it.

Both the elements of the Berkshire system and their collected size are quite unusual. No other large corporation I know of has half of such elements in place.

How did Berkshire happen to get a corporate personality so different from the norm?

Well, Buffett, even when only 34 years old, controlled about 45% of Berkshire's shares and was completely trusted by all the other big shareholders. He could install whatever system he wanted. And he did so, creating the Berkshire system.

Almost every element was chosen because Buffett believed that, under him, it would help maximize Berkshire's achievement. He was not trying to create a one-type-fits-all system for other corporations. Indeed, Berkshire's subsidiaries were not required to use the Berkshire system in their own operations. And some flourished while using different systems.

What was Buffett aiming at as he designed the Berkshire system?

Well, over the years I diagnosed several important themes:

- (1) He particularly wanted continuous maximization of the rationality, skills, and devotion of the most important people in the system, starting with himself.
- (2) He wanted win/win results everywhere--in gaining loyalty by giving it, for instance.
- (3) He wanted decisions that maximized long-term results, seeking these from decision makers who usually stayed long enough in place to bear the consequences of decisions.
- (4) He wanted to minimize the bad effects that would almost inevitably come from a large bureaucracy at headquarters.
- (5) He wanted to personally contribute, like Professor Ben Graham, to the spread of wisdom attained.

When Buffett developed the Berkshire system, did he foresee all the benefits that followed? No. Buffett stumbled into some benefits through practice evolution. But, when he saw useful consequences, he strengthened their causes.

Why did Berkshire under Buffett do so well?

Only four large factors occur to me:

- (1) The constructive peculiarities of Buffett,
- (2) The constructive peculiarities of the Berkshire system,
- (3) Good luck, and
- (4) The weirdly intense, contagious devotion of some shareholders and other admirers, including some in the press.

I believe all four factors were present and helpful. But the heavy freight was carried by the constructive peculiarities, the weird devotion, and their interactions.

In particular, Buffett's decision to limit his activities to a few kinds and to maximize his attention to them, and to keep doing so for 50 years, was a lollapalooza. Buffett succeeded for the same reason Roger Federer became good at tennis.

Buffett was, in effect, using the winning method of the famous basketball coach, John Wooden, who won most regularly after he had learned to assign virtually all playing time to his seven best players. That way, opponents always faced his best players, instead of his second best. And, with the extra playing time, the best players improved more than was normal.

And Buffett much out-Woodened Wooden, because in his case the exercise of skill was concentrated in one person, not seven, and his skill improved and improved as he got older and older during 50 years, instead of deteriorating like the skill of a basketball player does.

Moreover, by concentrating so much power and authority in the often-long-serving CEOs of important subsidiaries, Buffett was also creating strong Wooden-type effects there. And such effects enhanced the skills of the CEOs and the achievements of the subsidiaries.

Then, as the Berkshire system bestowed much-desired autonomy on many subsidiaries and their CEOs, and Berkshire became successful and well known, these outcomes attracted both more and better subsidiaries into Berkshire, and better CEOs as well.

And the better subsidiaries and CEOs then required less attention from headquarters, creating what is often called a "virtuous circle."

How well did it work out for Berkshire to always include casualty insurers as important subsidiaries?

Marvelously well. Berkshire's ambitions were unreasonably extreme and, even so, it got what it wanted.

Casualty insurers often invest in common stocks with a value amounting roughly to their shareholders' equity, as did Berkshire's insurance subsidiaries. And the S&P 500 Index produced about 10% per annum, pre-tax, during the last 50 years, creating a significant tailwind.

And, in the early decades of the Buffett era, common stocks within Berkshire's insurance subsidiaries greatly outperformed the index, exactly as Buffett expected. And, later, when both the large size of Berkshire's stockholdings and income tax considerations caused the index-beating part of returns to fade to insignificance (perhaps not forever), other and better advantage came. Ajit Jain created out of nothing an immense reinsurance business that produced both a huge "float" and a large underwriting gain. And all of GEICO came into Berkshire, followed by a quadrupling of GEICO's market share. And the rest of Berkshire's insurance operations hugely improved, largely by dint of reputational advantage, underwriting discipline, finding and staying within good niches, and recruiting and holding outstanding people.

Then, later, as Berkshire's nearly unique and quite dependable corporate personality and large size became well known, its insurance subsidiaries got and seized many attractive opportunities, not available to others, to buy privately issued securities. Most of these securities had fixed maturities and produced outstanding results.

Berkshire's marvelous outcome in insurance was not a natural result. Ordinarily, a casualty insurance business is a producer of mediocre results, even when very well managed. And such results are of little use. Berkshire's better outcome was so astoundingly large that I believe that Buffett would now fail to recreate it if he returned to a small base while retaining his smarts and regaining his youth.

Did Berkshire suffer from being a diffuse conglomerate? No, its opportunities were usefully enlarged by a widened area for operation. And bad effects, common elsewhere, were prevented by Buffett's skills.

Why did Berkshire prefer to buy companies with cash, instead of its own stock? Well, it was hard to get anything in exchange for Berkshire stock that was as valuable as what was given up.

Why did Berkshire's acquisition of companies outside the insurance business work out so well for Berkshire shareholders when the normal result in such acquisitions is bad for shareholders of the acquirer?

Well, Berkshire, by design, had methodological advantages to supplement its better opportunities. It never had the equivalent of a "department of acquisitions" under pressure to buy. And it never relied on advice from "helpers" sure to be prejudiced in favor of transactions. And Buffett held self-delusion at bay as he underclaimed expertise while he knew better than most corporate executives what worked and what didn't in business, aided by his long experience as a passive investor. And, finally, even when Berkshire was getting much better opportunities than most others, Buffett often displayed almost inhuman patience and seldom bought. For instance, during his first ten years in control of Berkshire, Buffett saw one business (textiles) move close to death and two new businesses come in, for a net gain of one.

What were the big mistakes made by Berkshire under Buffett? Well, while mistakes of commission were common, almost all huge errors were in not making a purchase, including not purchasing Walmart stock when that was sure to work out enormously well. The errors of omission were of much importance. Berkshire's net worth would now be at least \$50 billion higher if it had seized several opportunities it was not quite smart enough to recognize as virtually sure things.

The next to last task on my list was: Predict whether abnormally good results would continue at Berkshire if Buffett were soon to depart.

The answer is yes. Berkshire has in place in its subsidiaries much business momentum grounded in much durable competitive advantage.

Moreover, its railroad and utility subsidiaries now provide much desirable opportunity to invest large sums in new fixed assets. And many subsidiaries are now engaged in making wise "bolt-on" acquisitions.

Provided that most of the Berkshire system remains in place, the combined momentum and opportunity now present is so great that Berkshire would almost surely remain a better-than-normal company for a very long time even if (1) Buffett left tomorrow, (2) his successors were persons of only moderate ability, and (3) Berkshire never again purchased a large business.

But, under this Buffett-soon-leaves assumption, his successors would not be "of only moderate ability." For instance, Ajit Jain and Greg Abel are proven performers who would probably be under-described as "world-class." "World-leading" would be the description I would choose. In some important ways, each is a better business executive than Buffett.

And I believe neither Jain nor Abel would (1) leave Berkshire, no matter what someone else offered or (2) desire much change in the Berkshire system.

Nor do I think that desirable purchases of new businesses would end with Buffett's departure. With Berkshire now so large and the age of activism upon us, I think some desirable acquisition opportunities will come and that Berkshire's \$60 billion in cash will constructively decrease.

My final task was to consider whether Berkshire's great results over the last 50 years have implications that may prove useful elsewhere.

The answer is plainly yes. In its early Buffett years, Berkshire had a big task ahead: turning a tiny stash into a large and useful company. And it solved that problem by avoiding bureaucracy and relying much on one thoughtful leader for a long, long time as he kept improving and brought in more people like himself.

Compare this to a typical big-corporation system with much bureaucracy at headquarters and a long succession of CEOs who come in at about age 59, pause little thereafter for quiet thought, and are soon forced out by a fixed retirement age.

I believe that versions of the Berkshire system should be tried more often elsewhere and that the worst attributes of bureaucracy should much more often be treated like the cancers they so much resemble. A good example of bureaucracy fixing was created by George Marshall when he helped win World War II by getting from Congress the right to ignore seniority in choosing generals.

Sincerely,

Charles T. Munger